

## Rethinking the "Law and Finance" Paradigm

Katharina Pistor\*

### I. INTRODUCTION

The label "Law and Finance" stands for a body of literature that has dominated policy-making and academic debates for the past decade. The literature has its origin in a series of papers co-authored by Andrei Shleifer, Rafael La Porta, Florencio Lopez-de-Silanes and a cohort of other researchers, including Robert Vishny, Simeon Djankov et al. (hereinafter referred to as LLS et al.).<sup>1</sup> More than ten years after "Law and Finance" was first published, it seems appropriate to step back and consider the contribution this literature has made, but also to point out where it has gone astray and deviated attention from what the critical issues are for Law and Finance and, more broadly, for law and development. The lead authors of this literature have given their own assessment of theirs as well as of related work in a paper that has recently been published by the Journal of Economic Literature, which I will refer to throughout this essay.<sup>2</sup> The second part of this essay will be devoted to a critique of the Law and Finance paradigm. The third part will sketch out alternative strategies for analyzing the role of law and legal

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\* Michael I. Sovern Professor of Law, Columbia Law School. I would like to thank participants at the symposium on "Evaluating Legal Origins Theory" for insightful comments and suggestions. Thanks also to my co-author Curtis Milhaupt for the book *Law and Capitalism* on which the analysis in Part II of this paper rests. All remaining errors or misrepresentations are mine.

1. The original paper is Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Law and Finance*, 106 J. POL. ECON. 1113 (1998) [hereinafter La Porta, et al., *Law and Finance*]. The paper Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer & Robert W. Vishny, *Legal Determinants of External Finance*, LII J. FIN. 1131 (1997) [hereinafter La Porta et al., *Legal Determinants of External Finance*] was published earlier, but builds on *Law and Finance*. The difference in publication dates is most likely related to the pace of publication at different journals. Several other papers test specific applications of the paradigm established in this work. They will be referred to later in this paper if and when relevant. Conceptually more important is Simeon Djankov, Edward Glaeser, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The New Comparative Economics*, 31 J. COMP. ECON. 595 (2003), as they seek to explain the origins of different types of legal systems.

2. Rafael La Porta et al., *The Economic Consequences of Legal Origins*, 46 J. ECON. LITERATURE 285 (2008).

institutions and the relation between legal and economic change in comparative perspective.

## II. CRITIQUE OF THE LAW AND FINANCE PARADIGM

Before developing the critique it seems useful to summarize the key arguments of the Law and Finance literature. First, countries can be divided into different legal traditions, or legal origins. The most important divide is between the common law system and the civil law system.<sup>3</sup> Second, legal indicators that measure the protection of owners, investors, and those that are generally “business friendly”<sup>4</sup> differ among countries with different legal origins. In general, common law countries are more business friendly than civil law countries. Third, common law countries are also associated with better-developed financial markets. Fourth, law is a determinant (cause) of the observed economic outcomes.

My critique of this paradigm can be summarized in three points: (1) the extrapolation fallacy; (2) the transmission problem; and (3) the exogeneity paradox.

### A. *The Extrapolation Fallacy*

The practice of developing theories about complex systems, such as markets, society, or law, from simple micro-level models (contractual relations) gives rise to an extrapolation fallacy. This strategy assumes that a market is equivalent to the sum of all contracts or can be fully explained by multiplying stakeholder relations at a single firm by the number of firms in the market. The extrapolation fallacy permeates economic theories and thus is not a critique specifically of the work of LLS et al. Indeed, economics has so far failed to offer a comprehensive theory of the market, and instead focuses on contracts, property rights, and firms. As is well

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3. This is obviously not an original finding but builds on well-established traditions in comparative law. The literature is voluminous. For several of the most well-known accounts, see RENÉ DAVID & JOHN E.C. BRIERLEY, *MAJOR LEGAL SYSTEMS IN THE WORLD TODAY* (1985); KONRAD ZWEIGERT & HEIN KÖTZ, *INTRODUCTION TO COMPARATIVE LAW* (1998); John Henry Merryman, *On the Convergence (and Divergence) of the Civil Law and the Common Law*, 17 *STAN. J. INT'L L.* 357 (1981).

4. This is the standard used for the World Bank's Doing Business reports, for which and with whose funding many of the indicators have been created. For details, see <http://www.doingbusiness.org/>.

known, even this categorization is a relatively late development and one that has not come easy to classic economics, which treated a firm simply as a production function. In 1937, Ronald Coase famously posed the question why firms exist, i.e., why we observe not only arms length contractual relations among individuals, but also vertically integrated organizations.<sup>5</sup> This question triggered (with some lag effect) a new sub-discipline: the theory of the firm.<sup>6</sup> Explaining who or what populates markets does not answer the question, what markets are and how they are constituted. To most economists this is not a relevant question, as markets are assumed and therefore don't need to be explained. According to this view markets represent the state of nature. Firms, law, and other features are the non-market features that require explanation. It is fully consistent with this basic assumption to explain the emergence of firms as a response to market imperfections—whether rooted in transaction costs<sup>7</sup> or incompleteness of contracts.<sup>8</sup> Law and legal institutions feature as accidentals to these market imperfections. Because markets are burdened by transaction costs, firms exist; and since firms are replete with agency costs, law is needed to mitigate these costs.

This line of reasoning has been clearly spelled out in an earlier paper by two of the lead authors of the Law and Finance literature, Andrei Shleifer and Robert Vishny.<sup>9</sup> The logic of their argument is as simple as it is compelling if one accepts the above premises: Firms need capital to grow and expand. The most important source of

5. See Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937).

6. Major contributors to the theory of the firm include Williamson, Alchian, Demsetz, Jensen and Meckling, and Grossman and Hart, to name just a few. For their contributions, see specifically OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES, ANALYSIS AND ANTITRUST IMPLICATIONS: A STUDY IN THE ECONOMICS OF INTERNAL ORGANIZATION* (1975); Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 *AM. ECON. REV.* 777 (1972); Harold Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 *J.L. & ECON.* 375 (1983); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305 (1976); and Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 *J. POL. ECON.* 691 (1986).

7. See WILLIAMSON, *supra* note 6; see also Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 *J.L. & ECON.* 233 (1979).

8. See Grossman & Hart, *supra* note 6; Oliver Hart & John Moore, *Foundations of Incomplete Contracts*, 66 *REV. ECON. STUD.* 115 (1999).

9. Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 *J. FIN.* 737 (1997).

capital is external capital supplied by investors in the form of debt or equity. Investors will part with their money and invest in firms only if they can be assured that they will receive a return on their investment. Facing agency costs, investors will seek control over the firm in return for capital. This puts them into a position where they need to control the firm directly by acquiring a controlling stake. Firms that rely on external capital should therefore have highly concentrated ownership structures. However, when investors can rely on law and legal institutions to protect their interests they can afford to take smaller stakes. Rational investors prefer this because it allows them to diversify their investments across multiple firms. As LLS put it in their 2008 anniversary paper “legal protection of outside investors limits the extent of expropriation of such investors by corporate insiders, and thereby promotes financial development.”<sup>10</sup>

The leap from a micro-level issue—the financing of firms—to the macro-level issue—financial market development—is asserted, but not explained. The missing link following the above logic must be that legal protections not only facilitate diversification of financial commitments by the existing investor base, but also and in addition, must encourage small investors to put their savings in equity. This then leads to the broadening of the investor base, which is associated with bigger and deeper markets. Thus, law begets markets.

This causal nexus at the core of LLS et al.’s argument is that legal origin determines financial market outcomes. It does, however, question the key assumption in economics, which takes markets as a given.<sup>11</sup> It also passes over the fact that the market is now of a very different kind. It is no longer limited to relatively few, big investors, capable of exerting control over firms if they wish to do so. The number of investors has multiplied and the relation between investors and firms has become more complex. Facing information problems, investors rely on intermediaries for making allocation decisions, and on analysts and market watchdog institutions to collect and monitor firm specific information.<sup>12</sup> This results in a

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10. La Porta et al., *supra* note 2, at 285.

11. For a further exploration of this exogeneity paradox, see Section B below.

12. A substantial amount of literature seeks to explain in functional terms how all these different actors contribute to efficient markets. See JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984); Ronald J. Gilson

multiplication of agency problems that cannot possibly be addressed with firm level governance mechanisms, such as voting rights or "anti-director rights."<sup>13</sup> As Adam Smith argued in his *Lectures on Jurisprudence*, the increasing complexity of economic and social relations requires an increasingly complex set of rules and regulations.<sup>14</sup>

The point has not been lost on LLS et al. The early papers *Law and Finance* and *Legal Determinants of External Finance* still link the development of stock markets directly to firm level investor protection. However, subsequent work focuses specifically on securities law.<sup>15</sup> The choice of securities as opposed to banking law is interesting in and of itself and suggests a preference for financial markets that are closer to the idealized market that feature in the models of economists. Moreover, and not surprisingly, the conceptual framework remains unchanged. Securities law is depicted as an extension of individual investor protection.<sup>16</sup> Thus, mandatory disclosure rules are interpreted as facilitating private enforcement, rather than as a means for governing complex financial markets whose very existence depends on the accessibility and trustworthiness of information.<sup>17</sup> The specific role of regulators as lawmakers and law enforcers is downplayed if not ignored.<sup>18</sup> In a companion paper, the emergence of financial regulators in the U.S. is explained as a response to weak or corrupt courts, not as a necessary change in

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& Reinier Kraakman, *Investment Companies as Guardian Shareholders: The Place of the MSIC in the Corporate Governance Debate (Managerial Strategic Investment Company)*, 45 STAN. L. REV. 985 (1993); Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711 (2006).

13. This is the term LLS et al. use to refer to the shareholder rights index they created. See La Porta et al., *Law and Finance*, *supra* note 1, at 1127.

14. "The more improved any society is and the greater length the severall [sic] means of supporting the inhabitants are carried, the greater will be the number of their laws and regulations necessary to maintain justice, and prevent infringements of the right of property." 5 Adam Smith, *Lectures on Jurisprudence*, in THE GLASGOW EDITION OF THE WORKS AND CORRESPONDENCE OF ADAM SMITH, 16 (Ronald L. Meek et al. eds., 1982), available at [http://files.libertyfund.org/files/196/0141-06\\_Bk.pdf](http://files.libertyfund.org/files/196/0141-06_Bk.pdf).

15. Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1 (2006).

16. *Id.*

17. *Id.*

18. On the role of regulators as 'residual' lawmakers and law enforcers, see Katharina Pistor & Chenggang Xu, *Incomplete Law*, 35 J. INT'L L. & POL. 931 (2003).

governance called for by changes in the market place.<sup>19</sup> Thus, the market in the state of nature remains the ideal type against which markets in the real world are benchmarked. Institutional features are add-ons, not constitutive of markets. Their function is to bring the market close to its assumed true nature. The implication is that there is only a single optimal (efficient) market model and a single set of optimal rules that can bring it about.

The extrapolation from simple contractual models of the firm to complex financial markets does a disfavor to our understanding of markets and legal systems. If markets are rooted in legal arrangements, then the type of market that emerges is a product of political and legal choice, not an approximation of the state of nature. While it may still be useful to analyze what legal arrangements produce certain market outcomes, the choice of outcome variables is not a given (the “efficient market”), but becomes open to normative debate. Thus, it is not a foregone conclusion that bigger stock or credit markets are necessarily better—a lesson brought home by the global financial crisis.

Assuming that micro-level institutions, in particular the quality of investor rights protection in firms, are perhaps not the only, but still important determinants for market development one would expect that LLS et al. run the basic test whether countries with better legal protection do indeed have better financial systems. However, this would raise problems of reverse causality. It may well be, and indeed has been documented,<sup>20</sup> that law typically lags market development. Thus, better investor protections tend to be a response to market development and the crisis associated with it. The authors, therefore, emphasize a different finding, namely that “legal rules protecting investors vary systematically among legal traditions or origins.”<sup>21</sup> The choice of legal origin rather than rules on investor protection allegedly resolves the reverse causality issue, because the legal family

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19. Edward Glaeser et al., *Coase Versus the Coasians*, 116 Q.J. ECON. 853 (2001). For an alternative explanation on the rise of regulators in financial markets, see Pistor & Xu, *supra* note 18.

20. See Katharina Pistor et al., *The Evolution of Corporate Law: A Cross-Country Comparison*, 23 U. PA. J. INT'L ECON. L. 791 (2002) (documenting the development of corporate law in ten jurisdictions for a two hundred year period). Further analysis by the same authors suggests that intensive periods of legal reform coincide with periods of rapid economic development, at least for “origin countries,” not, however, for legal transplants. See Katharina Pistor et al., *Innovation in Corporate Law*, 31 J. COMP. ECON. 676 (2003).

21. La Porta et al., *supra* note 2, at 285 (summarizing the results of their earlier work).



countries belong to was for the most part determined by legal transplants. Legal origin can therefore be used as an instrumental variable for statistical purposes. In subsequent work by the same authors and numerous studies they inspired, the divide between these different legal traditions takes center stage. As LLS et al. and Djankov explain in their 2003 paper on the "New Comparative Economics,"<sup>22</sup> after the demise of the socialist system the new frontier of comparative system analysis has become legal origin.

The arguments and debates do indeed sometimes resemble the battle of ideologies during the cold war. In this debate the development of financial markets and its determinants has taken a back seat to legal origin. LLS and their co-authors ventured into studying the size of governments, formalism in court procedures, and barriers to entry as other applications of their legal origin theory. New and improved indices were developed over time and in their anniversary paper they finally come around to explaining that legal origin is not so much about specific legal rules, but rather about a mode of social ordering.<sup>23</sup> Nonetheless, the basic methodological approach, the extrapolation from simple models rooted in bilateral bargains to complex systems, has remained unchanged and so has the endorsement of the concept of a single, efficient model of market as the desirable outcome variable.

This approach not only underestimates the complexity of markets and their evolution, it also presents a rather crude picture of legal systems. Law is a complex system that cannot be reduced to the enforcement of property rights and contracts for the purpose of creating an ideal market.<sup>24</sup> That, however, is implied by theories that are based exclusively on bargaining models and seek to tip the bargaining process in favor of the investor constituency. To be effective, legal systems must be perceived to be legitimate;<sup>25</sup> i.e., they must be rooted in shared norms.<sup>26</sup> Specific legal rules reflect the

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22. See *supra* note 1.

23. La Porta et al., *supra* note 2.

24. An ideal market fails to materialize absent such legal prop-ups and, as the global financial crisis suggests, is capable of systemic failure even with such prop-ups in place.

25. Max Weber has stressed the importance of legitimacy in his attempts to explain different sources of authority, including legal authority. For details, see MAX WEBER, *ECONOMY AND SOCIETY: AN OUTLINE OF INTERPRETIVE SOCIOLOGY* (Guenther Roth & Claus Wittich eds., 1968).

26. Whether or not a legal system reflects shared norms depends on its genesis. Legal systems that result from wholesale transplants are much less likely to do so than are legal

compromise reached at a given point in time. Because legal change is slow and path dependent, a legal system more accurately reflects accumulated past bargains than current preferences. This does not preclude legal change, but such change could turn out to be spurious. Today's legal system of any country thus embodies a tension between past bargains—the preferences that have become institutionalized, i.e. codified in laws, precedents, and practices—and today's bargains spelled out in specific legal interventions, which may or may not be consistent with a country's legal legacy. This raises the question of how to capture the 'nature' of a country's legal system as opposed to superficial legal rules. In most of their work, LLS et al. side-step the issue by using specific rules to identify systemic differences between legal systems, in effect using similarities of rules within legal families as a proxy for a legal system. The implied justification is that common versus civil law systems differ systematically in their preferences for specific rules. But that could be superficial. Countries belonging to the same legal family may simply continue to borrow from lead countries of the legal family they belong to without necessarily subscribing to the norms these borrowed rules embody.<sup>27</sup> In fact most colonies have continued to borrow directly or indirectly from their colonizer's legal system, simply because this is the law their lawyers were trained with (and often the country they were trained in) and the institutions they are familiar with. In their anniversary article LLS et al. now seek to differentiate between deep-seated preferences, or the hard-wired features of a legal system on one hand, and specific legal rules, or its software on the other. However, they hardly resolve the tension between the two, which would imply that legal change superimposed on countries that belong to a different legal family that embodies a different set of normative principles is probably futile. Instead, they attempt to identify areas of the law where they believe change in

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systems that evolved in a more endogenous fashion. See Daniel Berkowitz et al., *The Transplant Effect*, 51 AM. J. COMP. L. 163 (2003). Note that LLS et al. concede as much in their anniversary article. See La Porta et al., *supra* note 2, at 326. But this is inconsistent with the very assumptions on which their research project rests.

27. There is indeed evidence that countries often copy blindly from others in the same legal family. See ROBERT CHARLES MEANS, UNDERDEVELOPMENT AND THE DEVELOPMENT OF LAW (Morris S. Arnold ed., 1980) (account of codification and re-codification processes in Colombia).



legal rules may alter economic outcomes,<sup>28</sup> without further explaining why that should be the case and why they selected these areas of the law in particular.

Moreover, the problem runs even deeper. It is by no means clear that the rules captured in the various indices LLS et al. have constructed reflect core features of the legal systems they are supposed to represent as opposed to spurious factors. Indeed, it has been shown that once the original data on shareholder and creditor rights are corrected based on more careful legal analysis, most of the results no longer hold.<sup>29</sup> Yet, numerous other studies by LLS and others suggest that there is a systematic difference between common law and civil law systems. As I have argued elsewhere,<sup>30</sup> these differences appear to be highly correlated with features identified by the socio-economic literature on comparative capitalism: This literature characterizes countries as 'liberal' or 'coordinated' market economies based on how they organize intra- and inter-firm relations.<sup>31</sup> It appears that most common law countries are liberal market economies and most civil law countries coordinated market economies. This would imply both different normative preferences and different legal rules. Notably, many of these coordinated market economies have done remarkably well in the post WWII period.<sup>32</sup> The latest interpretation of legal origin by LLS as a "highly persistent system of social control"<sup>33</sup> follows a similar trend. The authors have now distanced themselves from specific legal indicators and are instead emphasizing systemic features that result from the

28. La Porta et al., *supra* note 2, at 325. The areas of the law they identify include "entry regulations, disclosure requirements, or some procedural rules in litigation." *Id.*

29. Holger Spamann did this labor-intensive recoding effort. Holger Spamann, *Law and Finance Revisited* (Harvard Law School John M. Olin Center Discussion Paper No. 12, 2008).

30. Katharina Pistor, *Legal Ground Rules in Coordinated and Liberal Market Economies*, in *CORPORATE GOVERNANCE IN CONTEXT: CORPORATIONS, STATES, AND MARKETS IN EUROPE, JAPAN AND THE U.S.* 249, 249–80 (Klaus Hopt et al. eds., 2005).

31. See *VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE* (Peter A. Hall & David Soskice eds., 2001). Note that in contrast to the economics literature, in this approach the firm is not an anomaly of markets in need of explanation, but a core feature that reveals broader organizational features of markets and society.



32. See CURTIS J. MILHAUPT & KATHARINA PISTOR, *LAW AND CAPITALISM: WHAT CORPORATE CRISES REVEAL ABOUT LEGAL SYSTEMS AND ECONOMIC DEVELOPMENT AROUND THE WORLD* (2008) (showing that the propensity of common law and civil law countries to grow more rapidly is contingent on the time period selected).

33. La Porta et al., *supra* note 2, at 326.

institutionalization of past practices. This conceptual move, however, re-opens the Pandora's Box of causality between law and economic outcomes, which the authors sought to avoid by using legal origin as an instrument, which should not be directly related to the legal rules produced by it.<sup>34</sup>

### B. The Transmission Problem

The transmission problem addresses the causal nexus between legal origin, the specific legal provisions found in statutes and regulations, and economic outcomes. In their anniversary paper, LLS depict the relation between origin, legal rules, and economic outcomes in a flow chart that leads from "Legal Origin" to "Legal Institutions" to economic "Outcomes." A simplified version of the chart focusing only on the nexus described in LLSV (1998) looks like this:

Legal Origins  Company Law  Stock Markets

It remains unclear, however, how legal origin is linked to the specific rules that ultimately affect outcomes. LLS suggest that a country's legal tradition is the foundation for social outcomes and specific rules are the transmission belt between legal origin and outcomes. This could be interpreted to suggest that given a particular legal origin only certain rules are feasible; and that whatever the rules are, they are unlikely to affect outcomes if they conflict with basic features of the legal system that are not malleable to change.

The failure to explain the link between legal origin and specific legal institutions is particularly disconcerting when this framework is used for policy purposes. After all, most of the LLS et al. studies were sponsored by the World Bank and the World Bank has used the

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34. LLS et al. gloss over this point by arguing that the transplantation of law entailed not only the transplantation of rules, but also of other organizational features of law and legal systems. That, however, differs from country to country. Moreover, persistent differences between law exporting and law importing countries in terms of the level of rule of law today over 100 years after colonialism brought about the most extensive transplantation process, speaks against this assertion. On this point, see La Porta et al., *supra* note 2, showing that legal origin is not an important explanatory variable for outcome variables measuring legality; instead the manner of law development, i.e. whether it has been receptive or unreceptive.

indicators for assessing countries' legal systems and to motivate policy advice (Doing Business Project).<sup>35</sup> LLS concede that if their theory is correct, copying laws from the common law system and implanting it in a civil law system is unlikely to make much of a difference.<sup>36</sup> Yet, they reject the notion that this implies destiny and no hope for change.<sup>37</sup> Instead they argue that some rules can be changed without affecting the fundamentals of a legal system and that these rules will nonetheless affect economic outcome. Specifically, they argue, "[E]ntry regulations, disclosure requirements, or some procedural rules in litigation can be reformed without disturbing the fundamental of the legal system."<sup>38</sup> No explanation is given as to why these rules and not others can be modified without affecting the fundamentals of a given legal system; moreover, no evidence is provided whether the specific rules they mention did in fact have the desirable impact on outcomes in real world cases. This, however, would be crucial before their framework should be used as a blueprint for regulatory reform.

The underlying thrust of the argument appears to be that entrepreneurship is best left to its own devices and that the regulation of entry imposes unnecessary and socially harmful costs on business.<sup>39</sup> Reducing these costs should be compatible with any legal system. This reasoning assumes away the normative priors of different societies. Some societies may have a preference for preventing harm even if this comes at substantial costs, while others might prefer to address damages only once they have been caused. Thus, from a normative perspective, entry barriers are not only technical rules, or rent seeking devices, but reflect different values. It may, of course, be the case that the means used to realize these

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35. The first systematic compilation of legal indicators that were related to the ease of doing business in different countries was published in 2004. See WORLD BANK, DOING BUSINESS IN 2004: UNDERSTANDING REGULATION (2004). The database has been subsequently expanded and is now available online at <http://rru.worldbank.org/Documents/DoingBusiness/2004/DB2004-full-report.pdf>.

36. See La Porta et al., *supra* note 2, at 325 ("The [legal origin] theory indeed holds that some aspects of the legal tradition are so hard-wired that changing them would be extremely costly and that reforms must be sensitive to legal traditions.").

37. *Id.*

38. *Id.*

39. On the fallacy of this argument, see Benito Arruñada, *Pitfalls to Avoid When Measuring the Institutional Environment: Is Doing Business Damaging Business?*, 35 J. COMP. ECON. 729, 730 (2007) (suggesting that this rent-seeking interpretation misses the potential social values of entry barriers or other aspects of formality).

values are ineffective, socially wasteful, or both. Yet, disregard for the normative aspect of law and legislation can easily lead policy makers astray. It is relatively simple to change the laws on the books, but, as is well known and by now well documented, it is much harder to change established practices and the normative priors that inform them.<sup>40</sup> Investing resources in legislative change that can be easily undone by introducing counter-veiling rules or switching to informal practices is equally a social waste.<sup>41</sup>

LLS also assert that these “rules can point the reformer closer to where the problem actually lies”;<sup>42</sup> in other words, the legal variables they identify could serve as diagnostic tools for policy reform. This, of course, is true only if formal entry barriers, for example, are the root cause for large informal sectors and low entry into the formal sector and/or if there are no substitutes to formal entry barriers. In fact, it is equally possible that the standardization of rules will disguise rather than point to the root cause of the problems many countries are facing today. Specifically, if there are entrenched interest groups that seek to exclude new entrants, it is unlikely that a formal rule alone will transform the underlying power relations. If strong normative priors (or entrenched interests) speak against the liberalization of entry, other means can easily be found to restrict it—for example, by licensing particular types of activities or delaying other necessary permits (construction, zoning, etc.) that might be necessary for starting a business.

Finally, in the flow chart that depicts the relation between legal origin, legal rules, and outcomes, there is no feedback loop from economic outcomes to the institutions (the specific rules) or to legal origin. Suppose, however, the “market friendly” intervention of lowering entry barriers by changing formal rules succeeds and there

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40. See Berkowitz et al., *supra* note 26, at 179–90.

41. Take the following example, which Benito Arruñada cites in his paper, *supra* note 39, at 732 n.9:

[A]s a result of the reforms financed by the US development agency (USAID) and according to *Doing Business 2007*, Afghanistan has reached position 17 in the world for ease of setting up a business for which, according to this report, only three formalities are needed, taking about eight days (on-line data, 17 May 2007). However, Afghan entrepreneurs tell a different story. Although the actual company incorporation can be done fast, up to 18 months are needed to obtain the licenses required to start operating. The reforms have just postponed the most important restrictions until after the legal incorporation.

42. La Porta et al., *supra* note 2, at 326.

is an influx of new firms into the market. In LLS's world this would have an impact on economic outcomes, but would not affect the fundamentals of the legal system, which continues to re-produce rules that re-enforce legal origin. But why would one not expect that the influx of new entrepreneurs influence the direction of future legislation, which at least over time should also affect a legal system's fundamentals? Thus, if the basic premise is correct—that well functioning markets produce socially desirable outcomes—the experience of these benefits, and perhaps even more importantly, the changing political economy that results from such changes should leave an imprint on legal origin. Perhaps path dependence is simply too strong. Yet, if those feedback loops do not operate, why would anyone expect any lasting effect from changing a couple of formal rules even in the selected areas of the law LLS et al. suggest? Conceding that such feedback loops might exist would open the possibility for a new area of research on the political economy of legal change, which could ultimately prove to be more fruitful for policy considerations than the ideological battle about legal origin.<sup>43</sup>

### C. The Exogeneity Paradox

The legal origin theory and, even more so, the empirical results used to produce evidence in support of this theory are based on the assumption that legal origin is exogenous and that therefore we can isolate its effect from the effect of social systems (culture, politics, etc.). Yet, the legal origin theory is most powerful when applied to the origin countries (France, Germany, the UK, arguably the U.S.), not to countries to which these systems were transplanted.

As LLS state in their anniversary paper: "Although the evidence on reforms is just beginning to come in *and much of it is unfortunately confined to the developed world*, many countries seem to be moving toward market-friendlier government interventions. If the world remains peaceful and orderly, the attraction of such reforms will only grow."<sup>44</sup> This statement reveals the authors' normative goals: market friendliness.<sup>45</sup> While common law is not always and

43. For a summary of micro-level studies that explore the political economy of legal and institutional change, see Gani Aldashev, *Legal Institutions, Political Economy and Development*, 25 OXFORD REV. ECON. POL'Y 257 (2009).

44. La Porta et al., *supra* note 2, at 326 (emphasis added).

45. *Id.* For a critique of this normative bias, see also WORLD BANK, DOING BUSINESS: AN INDEPENDENT EVALUATION (2008), available at <http://web.worldbank.org/WBSITE/>

under all circumstances more market friendly, it is so most of the time, which is why it is the preferred model. From a development perspective the puzzle is that market-friendly policies are not always producing sustainable growth. LLS insist that the relevant transmission channels are financial markets, but in doing so they must assume that financial market development produces growth over time. Indeed, this is precisely what the authors suggest, although the caveats they include are important:

The world economy in the last quarter century has been surprisingly calm, and has moved sharply toward capitalism and markets. In that environment, our framework suggests that the common law approach to social control of economic life performs better than the civil law approach. When markets do or can work well, it is better to support than to replace them. *As long as the world economy remains free of war, major financial crises, or other extraordinary disturbances*, the competitive pressures for market-supporting regulation will remain strong and we are likely to see continued liberalization. Of course, underlying this prediction is a hopeful assumption that nothing like World War II or the Great Depression will repeat itself. If it does, countries are likely to embrace civil law solutions, just as they did back then.<sup>46</sup>

The paper was published in June 2008, just at the time the global financial market crisis unfolded. Given how few observers (including but not limited to economists) predicted that de-regulated financial markets could bring the entire global financial system to the brink of collapse, it would be unfair to hold this against LLS et al. However, two points can be made. First, if both political and economic stability is a precondition for the success of market friendly policies as implied by the above quote, then this should be factored into policy advice given to developing countries, many of which suffer from political and economic instability. Indeed, it has been suggested that the relentless pursuit of pro-market reforms in fragile countries may have exacerbated latent political and ethnic conflicts and further destabilized them.<sup>47</sup> Second, the statement seems oblivious to the

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46. La Porta et al., *supra* note 3, at 327.

47. Amy L. Chua, *Markets, Democracy and Ethnicity: Toward a New Paradigm for Law and Development*, 108 YALE L.J. 1 (1998). The argument is, of course, not novel. For an



series of financial crises that emerging markets have experienced over the past two decades, including the Mexico's Tequila Crisis (1994), the East Asian financial crisis of 1997/98; the subsequent crisis in Russia; and Argentina's meltdown in 2001. Long-term cross-country empirical evidence suggests that financial crises are highly correlated with preceding episodes of financial liberalization,<sup>48</sup> i.e. the introduction of 'market-friendly' policies and their legal correlates. A serious consideration of the experience of emerging markets in response to financial liberalization in conjunction with the recognition that the most convincing evidence on the benefits of the common law comes from developed countries should give one pause about the policy implications of this line of research.

The relation between crises and legal ordering noted in the second quote is also interesting. If crisis trigger the type of legislative interventions that are associated with civil law regimes, an analysis of crisis in recent history may be a better predictor for the nature of a country's legal regime than the historical origin of its legal system. Indeed, it is well known that crises tend to trigger extensive legislative responses. Thus, the stock market crash of 1929 in the U.S. was followed by wave of securities and banking regulations that strengthened centralized regulation vis-à-vis the states and self-regulatory organizations such as the stock exchanges.<sup>49</sup> Moreover, the experience with hyperinflation in Continental European countries in the aftermath of World War I has been associated with the "great reversal" in the management of financial markets.<sup>50</sup>

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account of how pro-market reforms have de-stabilized social relations in England, the mother country of the common law, see KARL POLANYI, *THE GREAT TRANSFORMATION* (1944). See also ROBERT H. BATES, *PROSPERITY AND VIOLENCE: THE POLITICAL ECONOMY OF DEVELOPMENT* (2001).

48. Graciela L. Kaminsky & Carmen M. Reinhart, *The Twin Crises: The Causes of Banking and Balance-of-Payment Problems*, 89 AM. ECON. REV. 473 (1999). In fact, some observers suggest that global financial crisis, which originated in the United States, is no exception. The only difference is that the liberalization of the subprime and derivative markets was, for the most part, informal rather than formal. See Carmen M. Reinhart & Kenneth S. Rogoff, *Is the 2007 U.S. Sub-Prime Crisis so Different? An International Historical Comparison* (Am. Econ. Rev. Papers & Proc., Working Paper Series, Paper No. 13761, 2008).

49. On the history of the New Deal financial regulatory reforms, see Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1 (1983) and Paul G. Mahoney, *The Pernicious Art of Securities Regulation*, U. CHI. L. REV. 1373 (1999). For a broader historical analysis, see Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 WASH. L. REV. Q. 849 (1997).

50. Enrico C. Perotti & Ernst-Ludwig von Thadden, *The Political Economy of Corporate Control and Labor Rents*, 114 J. POL. ECON. 145 (2006) (arguing that the great reversal,

Further, the experience with economic management during World War II has led the UK to nationalize substantial parts of its industry in the immediate post-war era. Thus, legal change seems to respond to economic and political events and sometimes to do so quite drastically. Indeed, according to the varieties of capitalism literature, both the UK and Ireland were classified as coordinated rather than liberal market economies for part of the post war period.<sup>51</sup> These changes are difficult to explain with recourse to legal origin. While many of these changes have been reversed, this too cannot simply be attributed to legal origin, but requires the introduction of human agency, and indeed of political economy.<sup>52</sup> In short, a consistent theory of legal development has to recognize that legal change is endogenous to political and economic change. That, of course, would challenge the notion that legal origin is exogenous and can therefore be used as an instrument for the purpose of econometric analysis—a premise that is crucial for the statistical validity of the work of LLS et al.

### III. COMPARATIVE ANALYSIS OF LAW AND LEGAL INSTITUTIONS: AN ALTERNATIVE APPROACH

The Law and Finance literature has made a major contribution in bringing the analysis of law and legal institutions to the forefront of comparative economics.<sup>53</sup> It is not surprising that a contribution of this scope and scale receives both applause and critique. In this section of this essay I will try to develop an alternative approach to

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which was identified as coinciding with World War I by Rajan and Zingales is associated with episodes of hyperinflation); see also Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the 20th Century*, 69 J. FIN. ECON. 5 (2003). For a critique of Rajan and Zingales, see La Porta et al., *supra* note 2, who question the accuracy of their data and point out that much of the market capitalization in French civil law countries came from government bonds. However, that should not be so troubling in light of the fact that even in England, corporate securities as a share of total securities traded on the London Stock Exchange exceeded government bonds only in the 1860s. See RANALD C. MICHIE, *THE LONDON STOCK EXCHANGE: A HISTORY* (1999).

51. See VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE, *supra* note 31, at 8–9.

52. Unfortunately, they try to prove the primacy of legal origin over politics and thus have downplayed politics in their analysis. This was primarily in response to Mark Roe's work, which stresses politics as a determinant of legal choice. See MARK ROE, *POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE* (2003).

53. Indeed, they have named this line of research the "new comparative economics." See Djankov et al., *supra* note 1.

analyzing the role of law in economic systems and the processes of legal change in light of the critique I have developed in Part II. This approach builds on my joint work with Curtis Milhaupt in our recent book on law and capitalism.<sup>54</sup>

The approach is based on the premise that countries differ not only with respect to their legal system, but also with respect to their economic system. In fact, we suggest that the relation can be depicted as a "rolling relation," in which changes and events in the economy give rise to legal change (or the use of existing law), and vice versa.<sup>55</sup> In contrast to LLS et al., we do not endorse a particular form of economic organizations—i.e. "the market"—as optimal or superior,<sup>56</sup> and instead suggest that different types of capitalist economies have proven remarkably successful in promoting economic growth and development. Capitalist systems by definition contain a strong element of markets, but the scope of markets and the way in which they are governed can differ considerably. The most impressive growth spurts in the post World War II period, those of the East Asian tigers and dragons in particular, and more recently of China, took place in countries with legal and economic systems that display features of centralized organization and coordination.<sup>57</sup> If different systems can be highly economically

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54. See MILHAUPT & PISTOR, *supra* note 32 (see especially the introductory chapter and the note on the "institutional autopsy" that precedes the case-study analysis).

55. *Id.* at 28.

56. See VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE, *supra* note 31.

57. There is a voluminous literature on the growth experience of these countries. See, e.g., ROBERT WADE, GOVERNING THE MARKET: ECONOMIC THEORY AND THE ROLE OF GOVERNMENT IN EAST ASIAN INDUSTRIALIZATION (2003); WORLD BANK, THE EAST ASIAN MIRACLE: ECONOMIC GROWTH AND PUBLIC POLICY (1993); ADB, EMERGING ASIA, CHANGES AND CHALLENGES (1997); ALICE H. AMSDEN, ASIA'S NEXT GIANT: SOUTH KOREA AND LATE INDUSTRIALIZATION (1989); YASHING HUANG, CAPITALISM WITH CHINESE CHARACTERISTICS (2008); BARRY NAUGHTON, A POLITICAL ECONOMY OF CHINA'S ECONOMIC TRANSITION IN CHINA'S GREAT ECONOMIC TRANSFORMATION 91 (Loren Bradt & Thomas Rawski eds., 2008); Yingyi Qian, *How Reform Worked in China*, in SEARCH OF PROSPERITY: ANALYTICAL NARRATIVES ON ECONOMIC GROWTH 227 (Dani Rodrik ed., 2003). For specific treatment on the legal development of major economies in East and Southeast Asia, see KATHARINA PISTOR & PHILIP A. WELLONS, THE ROLE OF LAW AND LEGAL INSTITUTIONS IN ASIAN ECONOMIC DEVELOPMENT (1999). For a comparative sociological account that emphasizes differences in the organization of firms even within Asia, see GARY G. HAMILTON & NICOLE WOOLSEY BIGGART, MARKET, CULTURE, AND AUTHORITY: A COMPARATIVE ANALYSIS OF MANAGEMENT AND ORGANIZATION IN THE FAR EAST, IN THE ECONOMIC ORGANIZATION OF EAST ASIAN CAPITALISM 111 (Marco Orru et al. eds., 1997).

successful it makes little sense to propagate that one is superior and must serve as a model for countries to grow and prosper. Instead, it may be more productive to try to understand under what conditions they can produce the desired economic outcomes. By the same token, each system may not only have strengths, but also weaknesses. We therefore posit that each system is likely to have its own inherent vulnerabilities, which need to be analyzed and understood in order to understand the trade-offs among different systems. Moreover, if—as we suggest—legal and economic systems stand to each other in a rolling relationship, attempts to locate the ultimate determinants for observed outcomes in either law or economics (or politics for that matter) must be futile as this suggests that the relation among these various factors is highly endogenous. A more productive approach then is to seek to understand the iterative process of change in each system and to situate the contribution that law makes to change. Clearly, this cannot be done by large *n*-studies, but requires a case-study approach.

Case-study analysis has received a bad name especially in economics; they are accused of being too specific to allow for generalizations; and to get bogged down by too many explanatory variables. Some of these problems can be avoided. This is true in particular for the excessive variables problem. A valid theoretical framework helps reduce the pool of reasonable explanations for case studies as it does for large *n*-studies.<sup>58</sup> Well-selected comparative case analysis (whether historical or cross-country) also helps focus the research.<sup>59</sup>

Case studies have advantages that cannot be replicated in large *n*-studies. They allow for context specificity as well as consideration of variables that may be relevant for some countries, but are irrelevant in other contexts. Moreover, they are less dependent on the availability of data for large samples; and lack of data often restricts the introduction of proper control, even outcome, variables. From the perspective of comparative law methodology case studies also have the distinct advantage of accounting for the fact that different legal systems may address the same problem in different ways. By simply asking whether a particular legal provision exists or does not

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58. See GARY KING ET AL., *DESIGNING SOCIAL INQUIRY* (1994) (describing in detail the “dos and don’ts” of such an analysis).

59. See CHARLES TILLY, *BIG STRUCTURES, LARGE PROCESSES, HUGE COMPARISONS* (1989) (describing the methodological aspects of such comparisons).

exist in another legal system, large n-studies commit what is widely regarded as a cardinal error in comparative institutional analysis: they assume that there is only a single solution to a problem. In fact, different legal systems can solve the same problem in numerous ways—most lawyers could even point to more than one solution within a single legal system. An approach that seeks to identify functional equivalents in different legal systems, of course, requires familiarity with law in different legal systems, which is why the sample of countries that can be concluded in such a comparative analysis will be bounded by the knowledge of the researchers conducting the study. And finally, case studies do not require the researcher to use a single parameter for all countries, such as restricting the analysis to a particular point in time—which may give the impression of neutrality or objectivity, but may bias the outcome (i.e. the year or period chosen may be an outlier, or reveal short term rather than long term trends). Comparability is, of course, important if one wishes to draw broader conclusions from a case study or proceed to comparative case analysis. What parameters are used therefore becomes a critical part of the research design. In principle, the same should apply to large n-studies. Thus, the choice to use stock market data for the year 1993 as the relevant outcome data by LLSV<sup>60</sup> could be questioned. Choosing the year 1987 or 2007 might produce quite different results. One response to this is to analyze longer trends, but this would also require coding legal data for more than one year, which requires enormous resources.<sup>61</sup>

For the purpose of the comparative case study analysis we develop in *Law and Capitalism* we use a major firm level corporate governance crisis as the parameter. Thus, we select countries from a restricted pool of countries that experienced a major corporate governance crisis in recent years—but without imposing a restriction that the crisis had to occur in the same year or affected the same type of firm. Crises can be described as outliers—implying that they should be discarded for understanding the normal state of affairs.

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60. See Rafael La Porta et al., *Law and Finance*, *supra* note 1.

61. Simon Deakin and his team have undertaken such an effort, but at least in the short term had to confine themselves to fewer countries in order to live up to their standards for comprehensive legal coding. For details, see John Armour et al., *How do Legal Rules Evolve? Evidence from Cross Country Comparison of Shareholder, Creditor and Worker Protection* (Univ. of Cambridge Working Paper Center for Business Research No. 382, 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1431008](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1431008).

Yet, crises are more likely to reveal critical features of a complex system that remain undetected in the normal state. The purpose of a crisis analysis is not primarily to understand the cause of a specific corporate governance failure, but to learn about the system in which this failure occurred. This is akin to the approach an academic pathologist follows when conducting an autopsy; it is not simply to understand the cause of death in this patient, but to learn about the human body. We therefore call our case study approach an "institutional autopsy." Moreover, by focusing on a crisis, we address one of the problems associated with case study analysis—the use of excessive numbers of variables. A differential diagnosis of the features that contributed to the crisis helps discriminate among possible explanatory variables and focus on those that are of primary relevance. An important condition for making these kinds of inferences is that it can be established that this crisis is not an outlier but representative of similar breakdown in a given country. This point re-enforces the point that contextualized system analysis requires familiarity with the system under investigation.

We hypothesize that the nature of the crisis varies across different systems and is related to features of the system in which it occurred. We characterize legal systems along two dimensions: their organization and function. A legal system may be centralized or decentralized. The level of centralization refers to the allocation of power to affect legal change. Centralized systems tend to vest the power to affect legal change with large and well-organized interest groups. Decentralized systems, in contrast, vest these powers with individuals who can initiate legal change, for example, by bringing a lawsuit or challenging the decisions of a regulator. Not every lawsuit will trigger legal change. Thus, the extent to which an individual or only a well-organized group with close connections to the center of power can affect the future path of legal development becomes of critical importance. An extreme version of centralization is state control; and we label the Russian legal system under Putin in this way. Beyond this extreme case there can be intermediate cases; the decentralization/centralization dimension thus describes a continuum, not a binary state of affairs.

The function of law also differs from system to system. A legal system's primary function may be to establish individual rights and empowerments as a matter of substantive law and to protect these rights by affording them procedural remedies. Instead, a legal system



may vest powers with groups or organizations, or allocate rights and entitlements to more than one constituency. This will compel individuals to organize or groups to cooperate with each other and/or with the state. We call systems that emphasize individual entitlements "protective" and those that emphasize cooperation "coordinative." Again, these are not discrete variables, but describe a continuum. There is some affinity between these two dimensions. Systems that are relatively centralized tend to be more coordinative; and systems that are more decentralized tend to be more protective. However, not all countries follow this pattern or do so in all areas of the law. Thus, the English legal system displays strong features of a decentralized and protective legal system; yet its takeover panel arrangements suggests a much greater willingness and institutional ability to coordinate than does the U.S. litigation based system.<sup>62</sup>

We hypothesize that the organizational and functional features of legal systems make countries prone to different types of crisis and are also like to trigger different responses to such crisis. Thus a centralized system can suffer from abuse at the center; it is also vulnerable to defection from established interest groups whether by incumbents who change allegiances or by new entrants who refuse to play by the rules of the established system and use available legal devices to challenge its viability. In contrast, a decentralized system is vulnerable to excessive agency costs in the complex monitoring and governance mechanisms inherent in such a system; it also tends to be slow in responding to crisis precisely because it lacks centralized coordination mechanisms. Attempts to correct for this might be challenged by individuals mobilizing their rights against centralization efforts.

This framework has certain affinities with the legal origin debate, but also departs from it in important ways. The decentralized, protective mode of legal system fits the idealized description of the common law system; and the centralized, coordinative mode reflects important features of the civil law system. However, whereas LLS depict legal origin as an immutable, hardwired feature our framework allows for change over time. It is also more amenable to detecting changes within each legal family. Thus, as indicated above, in

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62. This contrast and its economic efficiency is discussed in detail by John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of U.S. and U.K. Takeover Regulation* (UCLA, Working Paper, No. 73, 2006), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=928928](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=928928).

corporate law we find important differences between the UK and the United States. Moreover, Singapore, a country that features in our case analysis of the China Aviation Oil Company on the Singapore stock exchange, can be classified as a common law country by legal origin. However, our institutional autopsy reveals that the crisis resolution does not occur in a decentralized rights based fashion that is associated with the common law. Instead, it is closely coordinated at the center. Similarly, Germany, Japan, Russia, and South Korea—the four ‘civilian’ systems we study—all belong to the Germanic civil law family. Still, the degree of centralization as well as the constituencies empowered to partake in the coordination of economic and social relations differ markedly across these countries. Lastly, our framework does not take law as a given, but investigates the role of legal change in relation to a crisis. This includes an analysis of the contribution law or specific legal rules may have made to the crisis we investigate; but also of the ways in which law is mobilized (and by whom) in response to the crisis. In other words, we are interested in law in action, not in the law on the books, neither in law applied to hypothetical cases, which may or may not be relevant to the economy in question.<sup>63</sup> What we find in general is that as a result of international efforts to standardize law and establish best practices, the law on the books is increasingly converging. One of the most interesting examples in this respect is the codification of the Delaware takeover case law into soft law guidelines in Japan.<sup>64</sup> Closer inspection, however, reveals that the meaning and usage of these laws differs in different countries. Thus, in Japan the verdict is still out whether the anti-takeover guidelines will facilitate the development of a more vibrant takeover market or rather entrench existing interest groups that mobilize poison pills and other takeover devices that are permissible under Delaware law to fend off any attempt to challenge their dominance. So far the evidence points in the latter direction. Similarly, in South Korea and Germany judges have assumed an important role as gatekeepers of

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63. Note that LLS et al. employed these two strategies. For a number of indices they constructed, they coded the law on the books (i.e. corporate law and securities law). See La Porta et al., *Legal Determinants of External Finance*, *supra* note 2; La Porta et al., *Law and Finance*, *supra* note 1; see also La Porta et al., *supra* note 2. For others they used hypothetical cases, i.e. the number of days it takes to evict someone from an apartment or to enforce a bounced check as a measure of a system’s formality. See, e.g., Raphael La Porta et al., *Judicial Checks and Balances*, 112 J. POL. ECON. 445 (2004).

64. See MILHAUPT & PISTOR, *supra* note 32, at 57.

the established normative system and have used their legal powers to protect these norms even as changes in the corporate law or business practice seem to push towards a more market-based or common law system. Thus, in South Korea judges sided with the management of a company the foreign investors of which sought to replace it by declaring their attempt to mount a proxy fight against management a takeover attempt. And in Germany the criminal legal system was mobilized against the pay out of golden handshakes to management that had caved into a hostile takeover bid and was about to take leave from the company. The fact that investors and financial intermediaries arbitrage around existing rules to maximize their interests is well known. But similarly, the guardians of established norms (however right or wrong they may appear to an outsider) can switch tactics to ensure that their voices will be heard, indeed that changes will be stopped if they threaten the very core of the system.

More generally, our systematic analysis of corporate crises in six different jurisdictions suggests that law is hardly ever the only or even the primary culprit of a crisis. Conversely, legal solutions are not necessarily the most important remedy. Much depends on who mobilizes law and to what ends. In short, our detailed case analyses shed light on the processes of legal change that are treated as black box in the large n empirical studies epitomized by the work by LLS et al. These insights highlight that actual change is contingent on non-legal factors and that therefore, any attempt to use the insights gained from the Law and Finance literature for policy purposes should be treated with great caution. As lawyers engaged in comparative legal analysis of long established "looks can be deceiving."<sup>65</sup> Moreover, once we recognize that legal systems are not simply the sum of the indicators that we can find in statutes or codes, but instead are broad systems of social ordering—as LLS concede in their 2008 article—the methodology for analyzing legal systems ought to change. To use once more a medical metaphor—the emphasis then shifts from large-scale epidemiological studies to the differential diagnosis of complex phenomena. While we may gain insights about the optimal treatment once we know the diagnosis of the underlying disease, the disease itself can hardly be identified with epidemiological means alone.

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65. Alan L. Beller et al., *Looks Can Be Deceiving—A Comparison of Initial Public Offering Procedures Under Japanese and U.S. Securities Laws*, 55 LAW & CONTEMP. PROBS. 77 (1992).

## IV. CONCLUDING COMMENTS

The purpose of this essay has been two-fold: First, to take yet another look at the literature spearheaded by LLS et al. and to assess its contribution to the broader questions of the evolution of legal and economic system and the proper role of policy interventions to alter their course. Second, it has described in a nutshell an alternative approach to legal and economic system analysis that uses case studies rather than databases with binary variables that are in turn compiled into indices and regressed against outcome variables. The paper emphasized in particular the limited insights the large n-studies can possibly provide for policy purposes. In conclusion it should be noted that this author agrees with the LLS that legal origin does represent a complex system of social ordering. This, of course, is not a new insight but one that comparative legal scholars have noted long ago. More importantly, however, it should trigger an adaptation in the methodological approach championed by LLS and numerous studies they have given rise to. Clearly, the benefit of data sets is that they create economies of scale. According to a recent article in *The Economist* on *Doing Business in 2010*, there are now 405 articles in academic journals and over 1000 working papers that replicate in broad terms the findings by LLS.<sup>66</sup> An open question is whether these statistics indicate that we are closer to an understanding of the interplay of economic and legal change. This author suggests that this may not be the case.

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66. *Reforming Through the Tough Times*, ECONOMIST 12-18, Sept. 10, 2009, at 71.