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Understanding Legal Systems

In Part II we conducted institutional autopsies of governance crises that have taken place around the world. Each of these studies allowed us to examine the dynamic interplay among law, markets, and the political economy within a particular system. Now we expand the analysis across systems, both to gauge how well the prevailing analytical approaches discussed in chapter 1 help us understand the phenomena witnessed in the six countries (not very well, we conclude) and to show that the alternative framework for thinking about how real-world legal systems operate we outlined in chapter 2 proves more helpful in understanding how law actually relates to markets. In addition, we show how our approach advances understanding of what globalization means for legal governance of economic activity.

The Institutional Autopsies and the Prevailing Approach

Recall Max Weber's famous assertion that a rational legal system is the foundation for the development of capitalism. This seems to have been interpreted by modern-day Weberians in the economics profession and the international lending organizations to mean that law's exclusive role in a well-functioning capitalist system is to provide protection, particularly through detailed statutory rules governing investors' and other property rights, complemented by an institutional infrastructure to enforce those rights in a neutral fashion.[1] It is a small step from here to the conclusion that these attributes are or should be shared by all legal systems in successful market-oriented economies.

The institutional autopsies we have conducted in this book, however, have demonstrated that broad classifications of legal systems reveal relatively little about the internal operation of legal systems, specifically changing

patterns of demand for and supply of legal governance. Our analysis suggests that the dominant classification scheme based on legal "families" is inadequate as an analytical framework. First, note that the classification scheme seriously understates differences among countries said to belong to the same legal family. The German legal system was the model for the Japanese and Korean legal systems. All three countries retain some basic similarities in the structure of their legal system—most notably in the basic code structure and organization of the judiciary—but as we have seen, the legal systems and the economic structures of these countries have deviated substantially over the course of the past fifty years, particularly in the extent to which they have embraced features of the U.S. legal system. The most recent example is Japan's departure from the German or European model in the design of its takeover regime in favor of Delaware judicial doctrine.

Second, note that the canonical classification has no explanatory power over the question why some legal systems belonging to the same family deviate from the supposed key characteristics of that family over time. Take the case of Japan again. At the mid-point of the twentieth century, its legal system bore the strong imprint of the German civil law system. By the beginning of the twenty-first century, it had become much more similar to the U.S. legal system in key areas of economic regulation, though the German system largely resisted such a move during the same time period. Japan's gravitation toward the U.S. system in practice did *not* occur immediately after U.S. principles of shareholders' rights and citizen participation in the legal system were introduced into Japan after World War II but decades later, when the socioeconomic underpinnings of its postwar governance system were cracking. In our view, this timing is critical, because it highlights the importance of the demand for law and the relevance of factors external to law. This dynamic interaction between economic and legal change goes completely unnoticed in a scheme that focuses on historical models and classification into legal families. Recall that one of the best explanations offered in the law and finance literature for the supposed superiority of the common law is that England created the jury trial in the twelfth century (Glaeser and Shleifer 2002)—a rather strong endorsement of the notion that systems are path-dependent! Yet our studies have shown substantial legal change over relatively short periods of time. Thus, for legal systems, explaining change is at least as important as explaining stasis. We devote chapter 10 to this topic.

Third, the countries analyzed in this book defy the notion that market-supportive law must have a uniform set of characteristics, particularly the protective attributes of the common-law systems identified as being of

great significance in the law and finance literature and World Bank reform agenda. Despite the formal classification of Germany, Japan, Korea, and China as civil-law countries, which, the empirical studies suggest, economically underperform in comparison to common-law systems, the growth experience of each of these countries had been called an "economic miracle" at some point in latter half of the twentieth century. Moreover, in the economic heyday of each, none of these legal systems as they related to economic governance was centered on property rights protections and private enforcement actions in the courts. This historical experience is supportive of the data we presented in chapter 1 suggesting that growth episodes vary over time and across countries and legal systems in ways that cannot easily be traced to a particular set of institutions or legal attributes.[2]

Finally, in none of the cases we examined were we able to trace the crisis, breakdown, or controversy in corporate governance to a specific "defect" in the law that could be remedied simply by adopting "better," more protective rules and enforcement institutions. Instead, the problems typically stemmed from deep-seated conflicts over the allocation of control and decision-making rights in society and from often equally deep-seated controversy about the very role that law should play in the country's economic governance structure. Conversely, we often saw that importation of new legal rules patterned after law in more advanced economies (typically the United States) had ambiguous, unintended, or delayed consequences for economic activity.

These findings defy attempts to fix governance problems according to the simple algorithm of importing legal rules from more advanced economies to plug holes in the legal systems of less advanced economies. More generally, they defy attempts to associate a particular type of legal system with higher economic growth or other attractive economic outcomes such as larger capital markets. Instead, as we urged in chapter 2, they call for a reconceptualization of the different ways in which legal systems are actually organized in support of markets and a new set of analytical tools with which to examine the challenges different types of legal systems face in supporting markets, which are changing constantly. We now turn to that task by returning to our analytical framework with evidence from the institutional autopsies.

The Organization of Legal Systems

An important organizational dimension of legal systems is their relative degree of centralization or decentralization. The degree of centralization

is determined by the number as well as the identity of social actors who participate in the production and enforcement of law. In principle, the more actors a system has, the more decentralized it is. Focusing on numbers of actors alone, however, may be misleading, because the size of all modern states makes direct individual participation in the production of law too costly. Thus, not surprisingly, representative forms of governance (organized interests) exist in every system we have analyzed. Even in the United States, which we describe as having the most decentralized legal system, active participation in the production and enforcement of law occurs via organized interests. But the nature of these organizations differs markedly from those observed in postwar Japan, Germany, and Korea. In the latter three countries, at least in the heyday of their postwar period of high growth, interest groups tended to be large, few in number, relatively stable, and possessed of cohesive policy agendas. These attributes endowed the organizations with considerable bargaining power vis-à-vis governmental actors and made them relatively accountable to their members. For example, unions and employer associations have influenced the production of law in Germany for decades, leading it to be described as corporatist in the literature about comparative capitalist systems. In Japan and Korea, business interests were well represented in the production of law, mostly by way of informal means of consultation among the business elite (acting on behalf of individual firms and, more important, through trade or industry associations), politicians, and bureaucrats. Moreover, as we discussed in chapter 2, the law-making process in all three countries partly insulated policy makers from direct lobbying by interest groups and relied instead on "committees of experts" or consultative bodies made up of interest group representatives, academics, and government officials.

The situation in the United States is different. Organized interest groups form an integral part of the political and social fabric, with lobbyists for virtually every policy issue that could conceivably be pursued by lawmakers and regulators in Washington. But the identity of these lobbying groups and their agendas are more fluid than those in Germany, Japan, or Korea. In the United States, from the perspective of stability and influence on lawmaking, the closest equivalent to German labor unions and employer associations is the organized bar. Yet the legal profession in the United States does not represent a common set of economic interests—other than those of legal professionals themselves—but rather promotes the ability of plaintiffs, whose interests vary from case to case, to join their claims and pursue legal remedies for a host of alleged rights infringements. The long-term impact of this group on specific policy outcomes is far less apparent

than is the case in the other countries. Rather, the legal profession plays a critical role in maintaining and advancing the basic structure of the U.S. governance system, namely, its decentralized nature and the prevalence of the protective function of law.

The actual changes experienced by legal systems around the world are better explained by leaving behind schematic classifications and historical origins and analyzing the interplay of existing governance structures and changes in the demand side of law at critical junctures in a country's history. Using the organization of a legal system as a critical parameter for predicting specific outcomes, we suggest that a legal regime that protects individual investors' interests will be produced in response to growing demand, provided that the system is sufficiently decentralized at that point to foster contestation of governance structures.

In the United States, for example, we observe the emergence of minority shareholder protection rules at the state and federal levels in the first two decades of the twentieth century (Pistor et al. 2002), a time when the ownership structure of firms was shifting from a concentrated to a highly dispersed form (Berle and Means 1932). The demand for better protection of minority investors' rights triggered a series of legislative interventions at the state level, as well as federal intervention after the stock market crash of 1929 (Mahoney 2001b). The demise of concentrated ownership and the diminished reputation of major financial institutions as a result of the crisis in the late 1920s undermined the banks' bargaining power and facilitated this change (Roe 1990). In the United Kingdom—the mother country of the common law—changes in the ownership structure of firms occurred later and never to the same extent as in the United States. Not surprisingly, legal change lagged behind as well, and important aspects of corporate governance continue to deviate from the U.S. model (Black and Coffee 1994). The interests of relatively large owners and major players in the marketplace prevented decentralization of corporate governance to the extent witnessed in the United States. Instead, coordination among these powerful private players has played a critical role in corporate governance in the United Kingdom. A major example is the U.K. Takeover Panel, a self-governing organization that manages disputes in a highly coordinative fashion.

This dichotomy between centralized and decentralized systems is agnostic with regard to state structure. The classification does not depend on whether a country has a federal or a unitary system of government. Nor does it matter whether the relevant players are state or private actors. It thereby departs from other usages of the centralization-decentralization

terminology that is common in the social sciences (Lieberman 2005).[3] The reason for this departure is that, in practice, the degree of centralization of a legal system does not correlate neatly with state structure. The United States, Germany, and Russia are all federal systems, but the allocation of law-making and law enforcement functions between the federation and its constituent parts (states, *Länder,* and *oblasts,* respectively) differs considerably among them. In the United States, jurisdiction over key areas of law, including corporate law, lies with the states, whereas they lie within the jurisdiction of the federation in Germany and Russia. More strikingly, in the United States, corporate law is made concurrently by many different actors at all levels of governmental structure. This includes the state legislatures but also state courts, state regulators, the Congress, federal regulators, and the federal courts. By contrast, in Germany and Russia lawmaking concerning virtually all matters related to the corporation is centralized at the federal level, and central government regulators play a dominant role in law enforcement. To the extent that courts play a role in enforcing corporate law at all—and that role is quite limited in Germany and Russia (Pistor and Xu 2003)—they are part of a unified judicial system.[4]

Furthermore, as the comparison between China and Russia suggests, a de jure unitary state can de facto be more decentralized than a federal state. China is formally a unitary state; Russia is a federal state. Yet China is substantially more decentralized in its governance structures than is Russia (Qian, Roland, and Xu 2006). This is in part a product of the Cultural Revolution, which undermined the central state bureaucracy and positioned local and regional governments as key actors at the outset of economic reforms. This devolution of de facto powers has been reinforced by a reform strategy that encouraged local experimentation and used competition among bureaucrats as a tool of governance (Huang 1996; Qian 2003; Pistor and Xu 2005). The Chinese experience also illustrates that even within a system where governance is controlled by state agents there can be substantial decentralization. It is therefore not always appropriate to associate higher levels of state control with greater centralization. Conversely, Yeltsin's Russia provided powerful evidence of state capture by private interest groups (Hellman, Jones, and Kaufmann 2003), contrary to the notion that private control of economic assets is necessarily associated with decentralized forms of control.

Different theories exist as to *why* some countries have a more or less centralized economic, political, or legal system. Gerschenkron (1962) famously attributed the organization of economic systems to the relative positioning of a country in the quest for economic development. Early

developers such as England were comparatively decentralized, whereas late developers had to make greater efforts to mobilize capital, giving rise to coordinated or even state-managed efforts toward capital accumulation. Djankov et al. (2003) attribute the organization of political systems to the challenges a state faces at some critical constituting moment. This moment defines and limits the potential scope for subsequent change. Damaška (1986) attributes the organization of legal systems to the political history of a country—witness the legacy of liberalism in England and feudalism in Continental Europe. Similarly, Glaeser and Shleifer (2002) trace the origins of legal systems to the political economy of England and France in the Middle Ages.

We do not attempt to offer yet another theory as to why some systems are more centralized than others. We simply note that throughout the world there appears to be a strong (but not perfect) affinity in the organization of the political, economic, and legal systems in a given country. Moreover, most commentators agree that the organization of the polity is an important predictor of the organization of a country's legal and economic systems.

Where we depart from existing theories is in the conclusion that typically follows from this analysis: that once these features are in place, the system follows a highly path-dependent process of institutional change. Instead, we argue that under certain circumstances the system as such—not only elements within systems—can and does change quite significantly. A critical variable for change in the organization and function of the *legal system* suggested by our institutional autopsies is a challenge (an economic or political crisis or entry of a new market actor) that undermines the position of the relevant social elites that govern each of the six systems we have analyzed—although the identity of these elites and their position within each system differs.[5]

In the United States, the indictment of Arthur Anderson and questions raised about the ability of other intermediaries such as lawyers, auditors, and boards of directors to adequately monitor the highly decentralized legal system provided the political opportunity for a legislative shift toward a more centralized legal system—at least as it relates to corporate governance—that relies more on mandatory regulation and less on the judgments and initiative of private intermediaries. In Germany, the changing composition of top management in flagship companies and their refocusing on international rather than domestic markets, paired with the weakening of labor unions, left the maintenance of the traditional postwar system to the criminal justice system. In Japan, the change in the ownership structure of firms, itself a result of the prolonged recession in the 1990s,

made the governance system vulnerable to new entrants who challenged the viability and legitimacy of the prevailing rules of market conduct. A similar process has occurred in Korea, although in that case the newcomer was a foreign investor. In the CAO case, a scandal threatened the existing order, although the collaborative efforts of Singaporean regulators and Chinese officials in control of CAO's parent company ensured that any serious challenge to the Chinese governance system was diffused. Finally, Putin's ascension to power and his relative independence from the oligarchs who had dominated the Yeltsin era stripped away the protections that had been available to Khodorkovsky.

The Functions of Law

On the functional dimension, we have characterized legal systems as either primarily protective or coordinative, with signaling and credibility enhancement serving auxiliary functions. The protection of individual property rights and contractual claims is often described as the core function of law in a market economy. In fact, the nature of the rights or entitlements that are protected in a market-oriented economy is determined by political compromises and depends on the balance of power among those who supply and demand law in a given country. The Yukos case illustrates the plastic nature of property rights protection. In this episode, the legal protection of creditors' rights turned into state control over private assets because the tax authorities were the firm's largest creditors. The case suggests that rules ostensibly designed for the protection of a particular stakeholder may be secondary in importance to access to judicial review by an independent and impartial judiciary. This in turn is a function of the willingness of the political rulers to subject themselves to legal constraints (Landes and Posner 1975; Ramseyer 1994). In fact, empirical data suggest that the de facto independence of the judiciary is a product of the competitiveness of the legal system (Stephenson 2003).

A legal system reveals itself as protective or coordinative in part in the design of substantive rules that allocate rights. Substantive rules or standards may announce a particular allocation of rights. Examples include the right of landowners to protect their property against intruders, the right of shareholders to elect a company's directors, the right of a tort victim to claim compensation, and so forth. But a clear allocation of rights ex ante that takes full account of all future claims is simply impossible.[6] Competing claims may arise over the right to emit noise or pollutants, the

right of nonowners to trespass on property (Coase 1960), or the ability of a large blockholder in a corporation to exercise its property rights without consideration for minority investors (Bebchuk 1999). Put differently, most substantive entitlements in any legal system are inherently mixed (Calabresi and Melamed 1972). A clear allocation of rights and entitlements ex ante is therefore difficult, if not impossible. A more important indicator of whether a legal system is protective or coordinative is how it purports to resolve competing interests. Some systems opt for litigation among competing claimants, each of them maintaining that they have an exclusive right. The function of the court then is to allocate this right to one of the parties. In practice, claimants often settle prior to a final ruling, not least in order to avoid the steep costs of prolonged litigation (Hughes and Snyder 1999). In this context, the allocation of legal rights serves as a coordinating device around which parties negotiate a settlement. Nonetheless, the availability of litigation provides an important "shadow of the law" for this kind of coordination.

Contrast this with systems that openly discourage formal mechanisms of dispute resolution and instead encourage or force competing claimants into less formal means of bargaining and coordination. An important example is Japan, where the number of lawyers admitted to bar in a given year is subject to state regulation. The quota has been increased, but the fact remains that government intervention affects the options available for dispute settlement. This is not to say that law plays no role in resolving disputes. In several areas special administrative agencies have been established to resolve social problems, including damages inflicted by malfunctioning consumer products, dangerous pollutants, and the like (Upham 1987). These agencies encourage mediation and bargaining instead of adversarial individualized dispute settlement. Another often-cited example of law's coordinative function is the German model of codetermination. By requiring that 50 percent of a company's board members be elected by employees, not shareholders, the law ensures that the interests of employees will be represented at the board level and not only on the shop floor. Their presence on the board gives employees critical information that they can use to challenge the implementation of policies to which they have not consented, though the decisive vote is typically held by the shareholder side.

Finally, recent legal developments in China suggest that lawmakers favor a coordinative role for law and enforcement institutions rather than a protective one. Recall that in investor disputes courts may grant civil damages only after the securities regulator (the CSRC) or the criminal justice

system has affirmed a violation of the law. Note the important gatekeeper function retained by the state over efforts to protect individual interests, ensuring that, at least in broad terms, the state coordinates responses to firm-level disputes. The Singaporean model of centralized law enforcement similarly places higher value on state-structured problem resolution than on the interests of affected individuals.

In the legal systems we have examined in this book, we detect a close affinity between coordination and centralization, on one hand, and protection and decentralization, on the other. The reason seems fairly straightforward: the difficulty of collective action make it costly if not impossible to coordinate atomized individual interests (Olson 1971). Effective coordination over long periods therefore requires a stable set of organized interest groups that can effectively act on behalf of others. To the extent that such groups dominate the production and enforcement of law, the legal system becomes more centralized. At the same time, since the groups exist largely to protect the interests of their members and by definition maintain close (often informal) connections with the state, legal governance in concentrated legal systems tends to reinforce coordination and to resist the centripetal pull of creation and enforcement of individual rights. Conversely, in societies organized around a plethora of constantly shifting interest groups, none of which enjoys stable and intimate access to the law-making and enforcement processes, the legal system is comparatively decentralized. In such a system, the protection of individual entitlements tends to be the central function. Thus, in our view, a more helpful way of understanding differences across legal systems around the world is seeing how they vary along two dimensions: centralized-decentralized and coordinative-protective.

We hasten to underscore several points. First, virtually all legal systems are blends of the two dimensions. Second, the polar ends of the functional dimension are mixed rather than pure: coordination often entails a degree of protection; protection often requires a degree of coordination. Third, the labels we have chosen are not intended to carry normative significance. No polar end of the spectrum represents an ideal type legal system. Indeed, the major thrust of the analysis thus far has been to reject the notion that one type of legal system is inherently superior to another.

Typology of Legal Governance around the World

In this chapter we reproduce the matrix we introduced in chapter 2 (figure 2.1). We have now situated the seven countries discussed in this book in

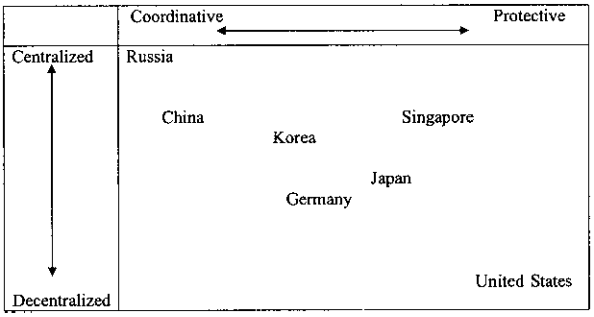

Figure 9.1. Legal systems matrix, completed

the space between the two axes (see figure 9.1). The matrix obviously serves only illustrative purposes, and the precise position of each country could be debated. The important point for our purposes is the relative position of individual countries vis-à-vis the others.

Based on our analysis of the institutional autopsies, we have located Russia and the United States at opposite corners of the matrix. Russia has the most centralized and least protective of the legal systems we analyzed; the United States has the most decentralized and protective. In Russia the state continues to play a major role not only in the design of law but in the use of law as a means to control the economy and society. In many instances this goes far beyond coordination as defined above and may be more aptly described as state ordering through law. Under Putin the state has regained a near-monopoly over law and limits the extent to which law can be used autonomously. A highly centralized structure allows only few agents outside the president's inner circle access to the law-making and law enforcement processes. Private parties therefore have few incentives to use the legal system except to use it against the state when this is the only line of defense available, however ineffective it might be in specific cases (Pistor 1996). Demand for law by private parties is therefore low. Consistent with these general characteristics, disputes against the state today far outnumber those filed against private parties.[7] These features make Russia's the least contested and contestable governance system among the seven countries we have analyzed. That is, parties outside the president's inner orbit have virtually no capacity to adapt the legal system to their needs or to participate in the process of legal governance. Instead, they use the legal system as a last resort to protect themselves against intrusions by the state.

The Yukos affair illustrates an attempt by an individual (albeit a rich and powerful one) to use the protective function of law to challenge a state

that had monopolized legal governance. We argue that Putin understood the nature of this challenge. He was keenly aware that granting full private autonomy and the protection of the law to oligarchs such as Khodorkovsky would weaken his ability to exert full control over Russia's economic and political systems. Nonetheless, the state's response to the challenge posed by Khodorkovsky was not unconstrained. The constraints, however, were external; they were not internal legal or political restraints on the exercise of government power. Instead, the Russian government's actions against Yukos had to be consistent with the objective of raising capital on international markets in order to realize the economic and political potential of Russia's rich resource endowment. They were therefore disguised as (pure) law enforcement actions. In fact, Putin emphasized repeatedly that the tax authorities and courts were in full compliance with the letter of the law. For now, this strategy has succeeded. Khodorkovsky is in jail, and Rosneft acquired Yuganskneftegaz in 2005 and the remainder of Yukos's most valuable assets in 2007.

The legal system of the United States presents a striking contrast. Private law enforcement is critical to many areas of economic governance and the "private attorney general" plays a key role in expanding the reach of law and increasing demand for the enforcement of private entitlements. Kagan (2001) argues that "the United States has by far the world's largest cadre of special 'cause lawyers' seeking to influence public policy and institutional practices by means of innovative litigation. In no other country are lawyers so entrepreneurial in seeking out new kinds of business, so eager to challenge authority, or so quick to propose new liability-expanding legal theories" (8–9). Even when the legislature creates an important new body of law (such as the securities laws) and a powerful central regulator (the Securities and Exchange Commission) is charged with its enforcement, in practice enforcement is often dominated by private attorneys and their clients. Under pressure from the private bar, which greatly expanded its powers after World War II (Witt 2007),[8] courts increasingly recognized private rights of action, which allowed private investors to sue issuers and underwriters and their agents for violations of the securities laws. As a result, the class-action securities suit has become the most powerful weapon for enforcing compliance and may now be serving as a substitute enforcement mechanism for some state law rules that are no longer meaningfully enforced in state courts (Thompson and Sale 2003; Coffee 2007).

Contrast this with the approach that courts in other countries have taken in similar situations. German and Japanese courts have denied a private right of action under the securities laws in the absence of explicit instructions

from the legislature.[9] In both countries, judicial deference not only to the legislature but also to the existing governmental enforcement apparatus appears to explain the result. By contrast, virtually every important public policy issue in the United States—economic or otherwise—is susceptible to legal challenge and often to multiple and even conflicting enforcement actions at different levels of the system, many of which provide alternative means of private participation in the law-making and enforcement processes.

The passage and aftermath of the Sarbanes-Oxley Act (SOX), discussed in chapter 3, is a prime illustration of the highly decentralized and contested legal system in the United States. The Enron crisis demonstrated that a governance structure that relies on multiple agents can, under certain market conditions (in this case a stock market bubble and misaligned incentive structures), succumb to the agency costs that are inherent in a system of decentralized monitors. A blizzard of legal responses followed the collapse of Enron. Numerous lawsuits were brought by attorneys on behalf of investors and pension plan beneficiaries in different states. Creditors filed claims in the bankruptcy court whose protection Enron had sought after it failed to find a white knight. They also initiated litigation against individuals for failure to disclose what they knew about Enron's problems. Prosecutors brought criminal charges against key players. The Securities and Exchange Commission and state attorneys general launched investigations against financial intermediaries that might have aided and abetted Enron in its fraudulent dealings. And of course, Congress enacted SOX.

The legislation sought to improve legal governance by establishing uniform central standards for governing publicly traded corporations and by establishing a new independent but state-monitored body that would monitor the auditing profession (the Public Company Accounting Oversight Board). The law can therefore be described as an attempt to centralize legal governance on the lawmaking side as well as on the regulatory or law enforcement side. On the regulatory side the act has arguably succeeded. The oversight board shifts regulation of the auditing industry from a self-governing, or decentralized, model toward a centralized one. The board has been actively establishing new standards, conducts regular inspections, and has launched a number of enforcement actions. With regard to firm governance, however, the result is far less clear. Firms regulated by the act have spent millions of dollars to bring their governance structure into compliance—the major beneficiaries being accounting firms, law firms, and consultants. This has taken place amid complaints about compliance costs and warnings that these costs undermine the competitiveness of the U.S. capital markets.[10] As a result, a government working group was formed

to study the question of exempting small firms from SOX's more costly requirements, and private-sector groups, at times with the endorsement of the Bush administration, sought to roll back some features of the law.[11]

The fact that shortly after SOX was enacted, concerted efforts at partial repeal were made (even as some vehemently argued that it did not effect meaningful change in the first place) demonstrates how powerful the centripetal forces in this system are and how strongly attempts at centralization are resisted. The most surprising aspect of SOX was perhaps that the law was enacted at all. Earlier attempts to address the costs of a highly decentralized legal governance structure did not fare very well. Consider the 1995 Private Securities Litigation Reform Act, which was supposed to address widely conflicting requirements for securities class-action suits based on fraudulent conduct.[12] The goal was to unify as well as raise standing requirements in order to filter out strike suits—those brought by law firms based on little evidence of malfeasance but in the hope of extorting a quick settlement from a firm that wishes to avoid prolonged litigation. What Congress in fact produced was a statute with a multiple personality disorder (Grundfest and Pritchard 2002) that failed to clarify the relevant procedural standards, as suggested by the different interpretations that emerged after the act was passed,[13] and that failed to effect any long-term reduction in the amount of securities litigation in the United States.

In sum, legal governance is probably more crucial to the U.S. economic system than to that of any other country in the world. In the United States, legal governance takes the form of decentralized contestation of individual rights and interests. This has many virtues, including allowing the governance system to respond flexibly to new challenges. The same attributes, however, have many costs. The most important of these are not lawyers' fees, the focus of so much public criticism. Rather, effective coordinated intervention is difficult, even when serious systemic weaknesses may call for such intervention. Moreover, passage of major legal reforms alone does not guarantee that they will be sustained or implemented as intended, given the tremendous pressures of decentralization, competition for enforcement authority, and incessant contestation of rules. The costs of such a system and its potential incompatibility with legal and economic systems organized around quite different principles are routinely overlooked by scholars and policy makers fixated on a single vision of "good law" for economic growth.

The other five legal systems examined in this book in detail are situated at various points between these two extremes. We included Singapore in

this matrix because the institutional autopsy of the CAO case involved an analysis of the Chinese and Singaporean legal systems. It is somewhat of an outlier because it defies the notion that protection and decentralization necessarily go together. Singapore (a common-law country) displays important features of protective law but uses state agents in enforcement practices that are closely coordinated. Although we do not have a case from the United Kingdom in our sample, we would suggest that it would fall somewhere between Singapore and the United States on the vertical axis of figure 9.1.

China shares with Russia a socialist legacy and an institutional inclination to manage economic and social affairs from the center. For example, we showed that the CAO crisis was resolved by coordination among powerful state actors and their agents in China and Singapore. Still, important decision-making power over economic and social affairs in China has devolved to the provinces and municipalities to some extent. Many reforms, including legal reforms introduced during the past three decades, originated at the provincial level and subsequently spread nationwide (Lubman 1995). The unifying force in this competitive administration continues to be the Communist Party. It exerts control today primarily by controlling the appointment and promotion of cadres and thus the careers of key bureaucrats across the country (Huang 1996). In the past, law tended to complement and support coordination by the state or was used largely for signaling purposes. Although the trends thus far are clearly reversible, law seems to be claiming some autonomous space in China. Private attorneys have brought suits to protect peasants against land seizure by the state (Pils 2005) and to protect shareholders victimized by fraud at the publicly traded SOEs in which they had invested (Chen 2003). These actions seek to assert a more protective function of law. Not infrequently, the attempts to create a more protective role for law have been rebuked or severely limited—as was the case, for example, with investor lawsuits as discussed in the institutional autopsy of the CAO scandal. Nonetheless, the institutional compromise that was eventually reached in China, which allows investors to bring legal action for misrepresentation if a state actor (the CSRC, Ministry of Finance, or prosecutors) has verified a violation, suggests that the state was unwilling or unable to completely suppress this bottom-up process of rights enforcement. It remains to be seen whether in the long run contestability can take hold in China.

Our institutional autopsy of the CAO case is consistent with this analysis. At first reading the case suggests that law can contest and even trump

state interests, at least when legal governance is invoked by foreign regulators. The firm went into bankruptcy, and enforcement actions were initiated against its management. The very fact that its Chinese parent company allowed these actions to take place without attempting another bailout of its subsidiary was a wake-up call to investors, who had relied on implicit state insurance. More important, the parent company itself was sanctioned for insider trading. This was a novelty for a Chinese state-owned company, and it is an open question whether sanctions would have been applied had the incident occurred in mainland China. The legal interventions by the Singaporean authorities signaled that law enforcement could be a means of contesting the control of Chinese state-owned enterprises over subsidiaries listed abroad. In the end, however, law did not fundamentally challenge the prevailing mode of governance. Instead, law enforcement actions were tailored to accommodate the crisis resolution negotiated by the major parties: CAOHC, on one hand, and Temasek on the other. The tailoring of the legal intervention to support the coordinated resolution of the crisis was made possible by the Singapore legal system—highly centralized in its own right—which discourages private enforcement and places state agents at the center of legal governance. The CAO episode did not challenge this governance system and triggered no further institutional reforms in Singapore; rather, it reinforced the existing organizational structure. The speed with which the crisis was resolved and confidence in the market reestablished silenced any doubts about the efficacy of Singapore's coordinative governance structure.

Germany, Korea, and Japan all are located toward the center of our matrix. This reflects the postwar role of major organized interest groups in the production and enforcement of law in these countries, though the nature of these interest groups varies considerably. Moreover, their composition and influence have changed quite considerably in recent years, as has the role of litigation as an alternative means of legal governance. In the postwar period, all three countries placed considerable constraints on access to decentralized judicial lawmaking and law enforcement. In Japan and Korea, for example, the size of the legal profession has been closely regulated by strict quotas on the number of candidates that can pass the bar examination in a given year. Although the number of new lawyers has been increased in recent years as a result of demand-side pressures see (Milhaupt and West [2004]), the fact remains that the state (and sectors of the legal profession itself) assiduously seek to control the size of the profession. Moreover, institutional barriers to litigation in these two countries, such as high filing fees in Japan and high thresholds for the exercise of

shareholders' rights in Korea, discouraged resort to legal governance.[14] Only when such barriers were abolished in Japan did the number of shareholder suits, for example, increase (West 2001). Similarly, in Korea, it took the Asian financial crisis to prompt lowering of the thresholds for exercise of shareholders' rights, after which derivative suits began to be filed for the first time in Korea's history. Partly in response to the difficult enforcement environment, many of the first such suits were brought by nonprofit shareholder interest groups rather than individual shareholders (Milhaupt 2004).

In Germany, litigation is common and widely used in principle (Ietswaart 1990). In the corporate context, however, litigation has been restricted purposefully to ensure that stakeholders bargain for mutually agreeable outcomes within the governance structures provided by law. Originally, shareholders could not litigate directly but had to force the supervisory board into action. Subsequent change empowered shareholders who represented a substantial part of the outstanding stock (at first 10 percent, later 5 percent and now 1 percent) to bring legal action should the supervisory board fail to take action. Thus, in the postwar period, all three countries shunned overt endorsement of the protective function of law in corporate governance, instead encouraging key stakeholders to coordinate their actions by raising the cost of access to courts and other formal mechanisms of governance.

All three, however, are increasingly incorporating more protective features into their legal systems. Several factors have contributed to this change. First, the power of organized interests has declined over time. Dwindling membership in labor unions has undercut their power in Germany, and the long recession in Japan and the financial crisis in Korea weakened organized interests that were central to the coordinative systems that emerged in the postwar era, in particular, banks, corporate groups, and bureaucrats in key economic ministries. Meanwhile, globalization has undermined the established bargaining systems in important ways. It created new market entrants who are not part of the established system, as well as new business opportunities for incumbents. It also provided means of exit from the domestic institutions for many of the most competitive firms (in the form of foreign capital and product markets, for example). These changes diminished the attractiveness and continued viability of the established bargaining system. The ensuing governance vacuum had to be filled in some way. In each of the three countries, to different degrees, the "something" was law—specifically, legal rights premised on a more decentralized and aggressive enforcement infrastructure.

The crises we examined in these three countries challenged the mode of legal governance, in particular by triggering debates about the proper role of law in the country's governance structure. Though not framed in the terms we have used, fundamentally the debate in Japan and Korea involved the questions of how much legal access and protection should be granted to newcomers and whether they were using the legal tools at hand properly. All three countries had already introduced reforms that strengthened the protective function of law. Unlike the investors in the CAO case, for example, the foreign investor in Korea (Sovereign) could bring its own legal action in court and did not have to rely on the judgment or benevolence of a regulator to seek a remedy. But Sovereign lost each of the legal battles it fought. The court appeared to interpret Sovereign's actions as a hostile takeover attempt and granted SK's management the right to defend itself. In its ruling, the court focused on the specific case before it and gave a formalistic legal interpretation to the questions presented. To an outside observer, it may appear that the court was biased in favor of SK's management. But it can easily be imagined that from the perspective of an honest judge trained in the Korean system,[15] the sudden attempt by an unknown foreign investor to oust the management of a major *chaebol* amounted to a threat not only to the firm's stability but to the foundations of Korea's system of governance.

This outcome notwithstanding, the fact that an investor mounted a sustained challenge to *chaebol* management using mechanisms prescribed by law, including a proxy battle and litigation, marks an important change in the governance of large Korean firms.[16] In the past, control over the *chaebol* by the founding families and their descendants was essentially uncontested, except perhaps by the government itself. It took an outsider to mount such an open challenge to the modus operandi. That Sovereign lost may therefore be less relevant in the long term than the impact its actions had on the corporate governance environment in Korea.[17] The availability of legal recourse, which was facilitated by the legal reforms of the late 1990s, together with the entry of new (foreign) players into a system that had relied primarily on coordination and informal governance among insiders has increased the contestability of governance.

Unlike the episode in Korea, the Mannesmann trial did not involve a direct confrontation between foreigners as the new entrants and insiders as the incumbents. Rather, it was a conflict among critical stakeholders of the traditional German governance system, some of whom defected as a result of globalization. Greater exposure of German firms to foreign markets, and in particular their participation in mergers and acquisition as both

targets and acquirers, has been accompanied by the introduction of different norms and practices that have challenged both informal norms and formal law. In the Mannesmann case, law was mobilized to defend rather than attack the existing governance system. Backed by public opinion, the prosecutor acted as the major defender of the system, and this position was endorsed by the courts. But important legal changes were introduced even as the case unfolded, and they paint a very different picture of the German legal system. Stakeholders who expected to gain from globalization and changes in Germany's governance structures, including corporations with an international profile as well as investors, played a critical role in supporting these changes. Legal reforms that were implemented before the retrial of Esser, Ackermann, and the other defendants was terminated in the fall of 2006 included important changes in corporate, capital market, and civil procedure laws. The combined impact of these changes is to strengthen the protective function of law. Shareholders and their legal advocates are the greatest beneficiaries. In the past, labor unions or banks might have blocked such change, but their relative bargaining power and stake in the traditional German governance system has changed. Labor unions have lost membership and public support. Banks have reduced their holdings in German corporations and turned to international capital markets instead.

The Mannesmann trial was not a catalyst for these changes. Rather, it generated controversy because a battle over the direction of Germany's governance systems was already under way. The final outcome of this contest is still uncertain. Although shareholder rights have been strengthened on paper, they still need to be tested in the courts. As in Korea and elsewhere, German judges have their own perceptions and value systems, which influence their interpretation of the law. And as previously noted, although decentralized law enforcement has become more feasible, cases remain scarce. Moreover, as evidenced in the Mannesmann case, the criminal justice system can be used to counter the forces of individualized contestation of law and uphold the social norms on which Germany's model of a market economy has rested.

As in Germany, the events that gave rise to the Livedoor case in Japan were triggered most directly not by changes in the law but by changes in the economic landscape. The ownership structures of Japanese firms underwent considerable change over the course of the 1990s. They became less concentrated and more heterogeneous as more foreign investors bought shares in Japanese firms. New entrants, including domestic players such as Livedoor, discovered that they could use the law to protect their interests. Unlike incumbents, they did not shy away from turning to law instead of

relying on bargaining within established networks. Incumbents who had relied on social norms that discouraged the use of legal contestation even when formally available were caught in a bind. They could either lobby for constraints on the protective function of law or they could respond in kind by mobilizing law for their own ends.

The arrest and successful prosecution of Horie also suggests that law is not only a weapon for new entrants; it can be used to defend the old system, as it has in Germany and in Korea. Nonetheless, the Livedoor episode seems to have enhanced the role of formal law as a governance device. Since the conclusion of the Livedoor litigation, several other hostile takeover attempts have generated litigation and important court rulings. A return to the kind of informal governance that dominated Japan's business relations until the early 1990s (see Milhaupt 1996) would now be too risky in the face of possible legal attacks. Changes in the demand for law have thus triggered legal responses in a system where a rolling relation between legal and economic change is now well established. These developments have propelled the Japanese governance system much further toward a decentralized and protective function of law than did the formal legal changes that were introduced by the U.S. occupation after World War II.

Globalization and Changing Demand for Legal Governance

In four of the cases we have analyzed—Mannesmann, Livedoor, SK, and CAO—exposure of a governance regime designed for domestic markets to international markets and practices was a prominent catalyst for change. This raises the question of whether the process of globalization enhances not only legal governance in general but the protective function of law in particular. Recall that the key finding of the law and finance research is that common-law systems are associated with larger capital markets. Thus, perhaps it is primarily the increasing importance of global capital markets that is driving the transition of many legal systems toward U.S.-style legal protections.

That outsiders are drawn to law as a tool to advance their interests is not surprising. Outsiders lack access to the networks of exchange and information on which insiders rely (Landa 1981; Kali 1999). Protective features of a legal system have the advantage of being accessible by anyone, particularly when complemented by open access and decentralized enforcement regimes. By contrast, coordinative governance systems, particularly when supported by legal systems that limit access to legal remedies and place many enforcement decisions in the hands of state actors, advantage

insiders rather than outsiders. Increasing participation of outsiders in governance systems around the globe might therefore put pressure on legal systems to embrace the protective function of law. In fact, emerging markets are often advised to change their laws in this fashion as a way to attract foreign capital flows (World Bank 2001). A natural conjecture is that systems of governance will converge in countries that participate in world markets.

We discuss the patterns of legal change and the likelihood of legal convergence in chapter 10. However, two points seem critical in assessing the implications of legal and governance change that we have analyzed in the present chapter. The first is that broad access to legal protection is likely to change the dynamics of governance in ways that are difficult to predict. Law can be mobilized for a variety of purposes and used to protect different interests. The actual use of law therefore has an inherently political dimension, regardless of how objectively neutral the law appears on its face. It is often assumed that shifting the resolution of conflicts from bargaining among stakeholders (or under the supervision of political actors) to courts will neutralize the political nature of disputes. In fact, it simply shifts the means of the contestation from new entrants demanding that incumbents grant them access on one hand, to an institution (the judiciary) that itself is embedded in the norms, practices, and beliefs of a given country, on the other.[18] In the SK and Mannesmann cases, courts performed the role of guardians of the basic social norms.[19] These norms tend to change at a much slower rate than formal law or markets.

The second point is that a new entrant (foreign or domestic) will take social norms into account when deciding whether to mount a legal attack on the prevailing governance system. Recall that in the SK case other foreign investors could have sided with Sovereign and brought about a change in management at the shareholder meeting in March 2004. They chose not to, because such a move would have entailed substantial costs for them in light of the prevailing normative system and power relations in the country. Similarly, Vodafone could have completed a hostile takeover of Mannesmann but chose to pursue a friendly merger though it was the economically more costly option, most likely because the company did not want to alienate the German domestic market, which after all was their intended target. The demand for legal governance, and in particular for a highly protective law, is determined not only by the availability of legal remedies and enforcement mechanisms (the supply of formal law) but also by the expected costs the exercise of legal rights may entail. Cost includes not only the actual expense of invoking the legal system's protection but

also the social or political cost of having deviated from the "accepted" institutional path. This cost-benefit calculus appears to propel an interesting dynamic in the process of legal change as a result of globalization. Often it seems that foreign players are adept at getting new formal legal changes adopted. Perhaps this is because their outside status gives them leverage to push for legislative change that domestic actors lack. But foreign players are often treated with considerable skepticism when they actually seek to *use* legal mechanisms for their own ends.

On the other hand, as the German and Japanese cases demonstrate, when players within the system make use of new legal tools or governance practices, they can be potent forces for challenging prevailing assumptions about how the world should operate, because their actions cannot be written off as the work of an outsider. Collective expectations form the very essence of institutions (Aoki 2001). Thus, the uncoordinated but cumulative efforts of foreign and domestic actors appear to make a powerful combination for inducing institutional change in an increasingly globalized world. Sill, the Singaporean example similarly suggests that as long as a governance regime is sufficiently responsive to the interests of foreign investors, the way it accomplishes this goal is far less relevant. Singapore has strong incentives to be responsive to investor interests in a way that more directly satisfies the demand for legal governance. It is a small country that faces stiff competition in its ambition to establish itself as an international marketplace in Southeast Asia. In fact, using a coordinative system plays to the advantages of a small countries governed by well-connected insiders. It has also allowed the country to be responsive to rather divergent interests—those of small investors from all over the world and those of China as the major supplier of firms to be listed on the Singaporean stock exchange. China seems to be poised to follow this example rather than converge on a U.S.-style decentralized and rights-focused legal system. The implicit (and sometimes explicit) claim that in order to achieve sustained economic success countries must endorse a court-centered system of decentralized and protective legal governance thus appears to be unfounded. In particular, informal and coordinative forms of governance have proved to be highly successful and long-lived, as the Japanese, German, and Korean examples demonstrate.

Conclusion

Our analytical framework has allowed us to examine legal systems as they operate in the real world. Some general lessons can be learned from the

comparative analysis of different legal systems based on our work thus far. The first is that legal systems can be classified according to two important dimensions: their organization and the major functions they perform. This classification has an affinity with the traditional distinction between civil-law and common-law systems, but our analytical framework is better suited to account for change over time within and across systems. Second, each system has its own costs and benefits and its own system-inherent vulnerabilities, which may trigger a crisis and, in the extreme case, collapse of the system. A decentralized system is prone to waste of resources that results from multiple contestations of identical issues at different levels. It may be captured by interest groups that benefit from contestation as such without respect to the social gains or losses derived from it. Most fundamentally, as the struggle to reach equilibrium in U.S. corporate governance after the Enron scandal has illustrated, some serious governance problems require coordination, not a blizzard of individuated and competing enforcement efforts. Conversely, coordinative systems may lend greater stability to a system and be less wasteful. What makes for stability in some contexts, however, may amount to petrification in others. Moreover, a coordinative system relies not only on formal processes that can be changed fairly easily but also on the capacity of important interest groups to organize themselves and engage in bargaining and monitoring with other interest groups. When changes in the broader environment undercut these groups, the overall system is weakened. This can result in greater decentralization and formal legal empowerment. It might also result in a greater centralization of governance in the hands of the state.

TEN

Legal Change

We began the description of our analytical framework by noting that the prevailing view of law's relation to markets is overly static, largely failing to account for the possibility that legal systems change. In fact, the institutional autopsies and chapter 9 have exposed legal change as an important feature common to all the systems we have studied.[1] We devote this chapter to an exploration of several important questions related to legal change, legal transplants, and legal harmonization and convergence. We begin with the simple observation that all countries constantly change some subset of the rules that form part of their legal systems via legislative change, regulatory change, or case law. The critical question thus is not whether countries change their laws but whether a country's legal *system* changes over time, and if so, what triggers such systemic changes. How do they affect the overall characteristics of legal systems, namely, their organization and function?

How Do Legal Systems Change? The Evolutionary Approach and Its Weaknesses

The question is deceptively simple: How do legal systems change? As noted at the outset of this book, some models of law and markets do not contemplate the possibility that legal systems change by means other than colonization or military occupation. Where the possibility of legal change is contemplated in the literature, the answer, often implicit, is that legal change is an evolutionary process. Robert Clark (1981) has stated the outlines of a theory about the evolution of legal systems more explicitly and cogently than most commentators, so we summarize his argument. Discussing the United States, Clark argues that the history of capitalist

enterprise can be divided into four stages and that the legal system responded by employing regulatory strategies appropriate to each stage. The first, the entrepreneurial (or "robber baron") stage, was assisted by laws that permitted the rise of the corporate form. The enactment of broadly enabling state corporation laws was the hallmark of this stage. The second stage witnessed the rise of the professional business manager, which required the legal system to develop stable relationships between these managers and public investors through the creation of accountability mechanisms such as disclosure requirements and conflict-of-interest rules. The federal securities laws and fiduciary relationships delineated in the corporate laws are the major legal manifestations of this stage.

In the third stage, financial intermediaries and institutional investors emerged as professional investment managers, splitting ownership into capital supply and investment. The legal system responded to this development with a welter of regulations designed to ensure the soundness of financial intermediaries, insulating public suppliers of capital from the insolvency of the intermediaries. In the fourth stage, the savings function was professionalized as workers delegated the authority to invest in particular financial claims to plan sponsors and other professionals. The legal correlate is the rise of financial consumer protection legislation such as ERISA, which regulates the terms of participation and benefits of the savers. Clark (1981) argues that in each new stage, the prior legal response is not abandoned; rather, a new regulatory strategy is added to the existing framework. Clark explicitly views this process in evolutionary terms: "[I]f we focus on the mechanisms of change, the way in which the institutions of each stage emerged seems roughly analogous to the evolution of species by natural selection" (569). But he argues that unlike the random mutation of genes, new institutional forms are preferentially selected for their efficiency advantages by the cumulative decisions of rationally self-interested capitalists.

It is a small step from this scheme to a universal theory of legal change in capitalist systems. Through a process akin to natural selection, advanced legal systems everywhere arrive at a comparable menu of strategies to address the common functional needs of market actors. Indeed, scholars of comparative corporate law have already articulated such a theory. Kraakman et al. (2004) claim that "the exigencies of commercial activity and organization present practical problems that have a rough similarity in developed market economies throughout the world, that corporate law everywhere must necessarily address these problems, and that the forces of logic, competition, interest group pressure, imitation, and compatibility

tend to lead different jurisdictions to choose roughly similar solutions to these problems" (4).

This universal evolutionary theory of legal change in capitalist systems has also been used to explain the phenomenon of legal transplants and predict the future direction of legal change. Mattei (1994), Ogus (1999), and others have suggested that legal borrowing reflects a drive toward efficiency. Competition among the producers of law in a "market for legal culture" influences legal evolution and determines which rules are transplanted from abroad. These commentators claim that ultimately, the lowest-cost legal doctrine is widely adopted to prevent migration of firms and markets to more favorable jurisdictions. Commentators who predict convergence of governance regimes rest their arguments on similar assumptions about legal change. The most ardent convergence theorists in comparative corporate law, for example, claim that widespread ideological agreement on shareholder wealth maximization as the most efficient way to organize capital in an economy will bring about similar rules of corporate law *and practice* around the world (Hansmann and Kraakman 2001).

At the stratospheric level of abstraction at which it is typically presented, the evolutionary theory almost certainly captures important features of the process of legal change in market-oriented societies. As markets change and mature, they throw off new and increasingly complex governance questions, some of which are answered by the legal system. One of the motivations in fashioning a legal response is efficiency, the desire to implement the most effective resolution of the problem at the lowest cost. Over time, societies with market-oriented economies face roughly similar governance issues and settle on a relatively standard menu of solutions to common problems of economic growth and development. So it is true, for example, as Kraakman et al. (2004) point out, that the corporate laws of all developed economies are broadly similar. No doubt comparative analysis of the antitrust laws, securities laws, intellectual property laws, and other laws of developed economies would reveal similar patterns of basic resemblance. Market economies are governed, more or less, by a similar constellation of laws and regulations that arise from the key requirements of any capitalist system: raising capital, allocating property rights, fostering the growth of financial intermediaries, policing predatory market conduct, facilitating the exit of failing firms from the market, and so on. We do not observe any developed market economies that are governed by, say, religious law, committees of elders, or a reign of terror. Nor do we see developing economies creating legal systems that deviate drastically from the basic constellation of laws and regulations found in developed economies. In that sense, the

convergence claim is accurate, and predictions of further legal convergence are probably quite safe.

The problem with the evolutionary approach to understanding legal change is that once one moves beyond simple abstractions, it does not tell us very much.[2] For example, it is true that a basic function of corporate law everywhere is to respond to agency problems. In no developed economy is all the capital required to finance firms provided solely by the entrepreneurs who run them from day to day, so agency problems are unavoidable, and it is the corporate law's task to respond. But as our institutional autopsies have illustrated (in rather dramatic fashion, we hope), the *location and severity* of agency problems in firms, as well as what might be called the *institutional inclination* to use law (corporate or otherwise) to address these problems, differ widely from system to system.

To take only one example, four of the countries examined in this book—the United States, Japan, Korea, and China—now all use independent directors in an attempt to address agency problems at the firm level. The corporate *laws* of different countries have converged on use of the independent director as a solution to an agency problem. But this fact reveals nothing about how these changes have affected the legal *system*, in particular, the diverse paths by which they arrived at this institution, the different ways in which "independence" is understood in the various countries, and the widely divergent agency problems in each country that the institution attempts to mitigate. These problems range from absentee political oversight of publicly traded Chinese firms with close governmental ties, to controlling shareholder exploitation of minority shareholders in the Korean *chaebol*, to potentially excessive managerial identification with employee interests in Japan, to the problems of highly dispersed share ownership and an ineffectual shareholder franchise in the United States. There is reason to doubt the efficacy of the independent director in the United States, the country where it originated (Bhagat 2002), although one can tell a convincing story about how independent directors complement other features of the U.S. corporate governance system as they have developed over the past fifty years (Gordon 2007). There is some evidence that independent directors may actually mitigate the controlling minority shareholder problem in the Korean context (Black 2006). Available evidence suggests that independent directors as currently utilized in Japan (Gilson and Milhaupt 2005) and China (Clarke 2006) are not very effective in addressing the respective agency problems afflicting these systems. Thus, sweeping the trend toward independent directors under the adjoining rugs of evolution and convergence guts the comparative analysis of this development by hiding its most important features.

Worse yet, the evolutionary approach can mislead theorists and policymakers. There are many problems with viewing legal change principally in terms of an evolutionary drive toward efficiency. Some of these problems have been identified by Roe (1996), who points out that legal change is affected by chaos, path-dependence, and punctuated evolution, which can result in the formation of institutions that deviate from the survival-of-the-fittest paradigm. (We believe that path-dependence as a brake on legal change may be overstated in the literature. We elaborate on this below.) At this point we wish to emphasize several other problems with this approach, focusing our analysis again on the *process* of lawmaking.

In doing so, we again depart from the endowment theories of law and legal systems. Legal systems do appear to have distinctive characteristics that color both the types of problems they face and the way in which they respond to them, a point we emphasized in chapter 9. Those traits, however, probably have little to do with the formal legal rules themselves, as the conventional taxonomists and the economists assume. Rather, they stem from the proclivities of the people who operate the legal system, the producers of law. Hadfield (2006), for example, argues that differences in "legal human capital" fostered by distinctive incentive structures for judges and lawyers in various legal systems produce the observable differences in the civil- and common-law systems. In the United States, the power of the bar as an interest group (or cartel, if you prefer Posner [1995]) has contributed enormously to the complex, decentralized, "judicialized" system of lawmaking we identified as a hallmark of the U.S. legal system.[3]

Countries with more highly centralized lawmaking traditions resist devolution of authority in this way, in part for social reasons (fear of a "litigation explosion"), but also because it represents a major threat to the small group of players with control over the law-making process. Centralized legal systems reduce pressure for decentralization by limiting the supply of lawyers and resisting introduction of mechanisms such as class-action litigation and contingency fees for attorneys. The basic point is that in any system, whether centralized or decentralized, the producers of law will tend to favor certain interests. In the market for law and legal services these interests can cause substantial deviation from the competitive model. It is plausible that decentralized law-making processes that emphasize the protective function of law complement dispersed share ownership patterns in the economy, whereas centralized and coordinative legal systems complement more concentrated corporate ownership patterns. But if true (and our case studies lend some support to this proposition), it suggests the existence of more than one evolutionary path for legal change. In fact, as we further

argue below, legal evolution does not necessarily follow a predetermined path (decentralized or centralized) for all time. Rather, changes introduced into a legal system may alter the process of future change.

Demand-side analysis similarly fails to support the view that legal change is an evolutionary path toward a single set of efficient legal structures. It is not simply that economic incumbents can block the passage of rules that would be more efficient for the economy as a whole. Certainly we have seen that phenomenon at work in our institutional autopsies (for example, the lack of investor protections in Korea during the heyday of the growth pact between the *chaebol* founders and authoritarian political rulers). We have seen as well the related phenomenon of crises creating political opportunities for the passage of law that would not have been possible in equilibrium owing to resistance from economic incumbents (for example, the Asian financial crisis and legal reform in Korea and the Enron scandal and SOX).

A less well noted but equally pernicious problem for the development of efficient law is one we alluded to several times in the institutional autopsies: sometimes economic incumbents use newly enacted "efficient" law in ways that increase social costs. In Russia, for example, the state is essentially using the new bankruptcy law to nationalize assets. In Korea, *chaebol* leaders use legal arguments in the courts (in addition to more traditional political connections and so on) to fend off challenges to their business empires. This paradox of law reform, which afflicts all societies to some extent, results from the basic pattern of development we noted at the outset of this book: legal change often generates adaptive responses by different actors, including state and private agents. Ex ante, it is impossible to create a legal rule that will only generate "efficient" behavioral responses, and in particular, a rule adopted across a range of economies facing very different governance challenges and a range of legal systems that differ in degree of centralization and function of law.

Overattachment to the simplified evolutionary model of legal change may also taint law reform efforts. It may prompt international organizations and collective bodies such as the European Union to pursue misplaced legal transplants and legal harmonization projects. If legal systems are believed to develop in stages correlated with economic development, and if the legal rules found in successful economies are (at least subconsciously) deemed to be effective precisely because they are in place in developed markets, a natural impulse is to encourage countries to skip over some stages of legal development by enacting law found in the type of markets to which they aspire. The transition economies of central and eastern

Europe have copied extensively from other jurisdictions to catch up with the West and to comply with entry requirements for the European Union. Empirical evidence, however, suggests that these reforms have had, at best, mixed results. Analyzing the relation between legal change in the area of investor rights protection and financial market development in twenty-four transition economies, Pistor et al. (2000) find that neither the level of legal protection nor legal change over time has had much impact on financial market development in the region. In fact, few of the laws that were introduced in the new member states of the European Union from this region addressed the specific governance problems they faced (Pistor 2004).[4]

A separate example of possibly misplaced legal reform efforts can be found in the IMF's response to the Asian financial crisis. The IMF required that Korea adopt the minority shareholder rights found in U.S. corporate law as a means of improving corporate governance. Yet as we have indicated, the nature of the agency problem affecting shareholders in U.S. and Korean firms differs dramatically. The continuing struggle to resolve the *chaebol* problem and the halting nature of corporate governance reform in post-crisis Korea at least suggests that U.S.-style legal protections, though helpful in certain respects, did not reach the core of the problem. Finally, note that the European Union pursues legal harmonization for countries at—and aspiring to be at—similar stages of economic development in order to eliminate barriers to growth. For reasons we explore below, however, harmonization policies may be ineffectual or harmful to the development of effective legal institutions for market activity.

How Do Legal Systems Change? A Demand-Adaptation Approach

If the evolutionary approach to legal change is accurate only in broad strokes and misleading in many respects, what is needed to clarify the picture? Inherent in the analytical framework with which we began this book is a powerful view of legal change centered on demand for governance. This demand-adaptation perspective generates very different predictions about legal change than does an efficiency-oriented evolutionary approach. First, it suggests that the supply of new legal rules alone is unlikely to change the legal system. This is because legal systems, which include enforcement institutions and the legal professionals who intermediate between the legal rules and the market actors on whom law operates, must be distinguished from law, that is, formal legal rules enacted by legislatures or regulations promulgated by bureaucrats.[5] Second, changes in the demand for legal

governance may affect the overall governance structure of a system absent formal legal change, because new constituencies may make use of existing yet dormant rules. Third, the most powerful determinants of change in the organization and function of the legal system are changes in the major constituencies (social or political elites) that affect the demand for law as a device for governance. Our six institutional autopsies illustrate the critical importance of the identity, interests, and relative power of those supporting a particular system of governance (whether legal or informal) for the potentially system-altering power of formal legal change.

The United States and Russia are examples of relatively stable systems that either have reverted or are in the process of reverting to the previous governance equilibrium following a crisis or economic shock—even a shock accompanied by major legal reforms, as in the case of the United States. As previously discussed, SOX sought to centralize lawmaking and law enforcement in response to the series of corporate governance scandals epitomized by the Enron debacle. But neither the crisis nor the legal actions taken in response to it altered the major protagonists in the U.S. system of highly decentralized legal governance: the organized bar and the multiplicity of federal and state law enforcement authorities. Not surprisingly, once the crisis subsided, centrifugal forces quickly began to undermine the attempt to centralize or simplify governance in the interests of investor protection.

In Russia the law reforms of the 1990s did not fundamentally alter the highly centralized nature of the political system and the de facto control that the Kremlin exerts over powerful economic agents. Laws that in other legal systems may be primarily used to enforce private investors' rights such as bankruptcy laws were used to reestablish central control over Russia's natural resources sector. Attempts by members of the new business elite that had emerged under Yeltsin to neutralize the Kremlin under different leadership by seeking foreign investments and playing by international rules concerning best (legal) practices were perceived by Putin as a threat, not as a natural or desirable result of the legal reforms of the post-Soviet era. In response, he used the newly created legal apparatus to reallocate control over assets from disloyal members of the elite to loyal ones, thereby entrenching centralized political control over the economy as well as the legal system.

By contrast, in Germany, Japan, and Korea we observe systems that are in disequilibrium because the constituencies supporting the previous governance regime have been weakened and new groups from inside and outside the country are competing not only for resources but also for the

appropriate form of (legal) governance. Globalization has led to a diffusion of governance practices from abroad into these countries and a greater outward orientation of domestic players on whose loyalty the old system had depended. The ensuing vacuum created opportunities for new entrants to challenge the governance structure. Legal change was not strictly necessary for these changes to occur; new players could push the boundaries using the old rules. Notice that in the cases of Germany and Japan, existing criminal law was used in an attempt to stabilize the system in the face of the new actors. At first glance, the mobilization of the criminal justice system to protect these fairly centralized and coordinative systems suggests greater centralization. Other legal changes adopted in both systems, however, could be used to counter these tendencies and lead to a greater decentralization of legal governance and a more protective (as opposed to coordinative) legal system. In Japan, this trend is already evident in the increasing amount of shareholder and takeover litigation. In Germany, the effect of legal change that vests greater procedural powers with individual shareholders still remains to be seen. As in Germany and Japan, new entrants in Korea have challenged the preexisting governance structure. Formal legal change introduced after the East Asian crisis has potentially rooted these changes more deeply than has been the case in either Japan or Germany. Yet the real impact of legal reforms in all three countries may depend in large part on the courts, whose stature in the governance structure of all three countries has been elevated. Their understanding and interpretation of the law will be critical in determining whether the evolution toward decentralization continues or whether the systems will be stabilized in their current intermediate state.

China may be best described as moving toward a decentralized governance structure as a result of changes introduced or tolerated by the ruling elite. Changes are permitted in an attempt to adapt governance structures to ensure the continuation of both economic growth and political control. Decentralized mechanisms of legal accountability (protection), such as shareholder suits, are tolerated because they may improve governance, but they are nonetheless viewed with suspicion because they could ultimately pose a challenge to centralized political control. Not surprisingly, access to the courts for this purpose was made contingent on a central regulator's first establishing a violation of the law. In other words, protective law enforcement is made contingent on coordination by agencies directly linked to centralized political control. As long as this persists, there will be inherent limits on the extent to which the Chinese legal system embraces decentralization.

In sum, formal legal change is not necessarily system-altering, even in times of crisis. This implies that economic change alone is typically not a good predictor of change in a legal *system*, at least unless the signal sent by formal legal change is powerful enough to provoke novel market or governance activities. Typically more is needed: a change in demand for legal governance by local constituencies generally brought on by a change in the composition of the constituencies. Demand is the motivation for legal change and the ongoing deconstruction and reconstruction of legal governance in the context of a changing market economy. We believe that the notion of contestability, a term we introduced in chapter 2, is useful in understanding the mechanisms by which law rolls with market change, and the degree of contestability is an important explanatory variable in differences in the rate and form of legal change around the world.[6]

Contestation

As we use the term, contestation is the process by which existing governance structures can be challenged and adapted to a changing socioeconomic environment in response to demand. Contestation may take the form of widespread political participation in the production and enforcement of law, but it is not limited to political contestation in a democratic system. Avenues for demand for alternative governance mechanisms to be expressed in the legal system may include access to courts or bureaucrats, politicians, or even business elites who operate as gatekeepers for centralized governance structures.

What determines the contestability of a given legal system? Our institutional autopsies suggest that contestability is a byproduct of a country's relative location along the two dimensions of legal systems that we outlined in our analytical framework. The more decentralized the production and enforcement of law, the more contested a system tends to be, and the more likely that legal change will occur in the courts and in private lawmaking efforts (contractual innovations, lobbying-induced regulations, or legislation). Contestation is possible in more centralized, coordinative systems, too, but demand for new governance forms in such systems is likely to be filtered through and mitigated by a different set of agents, such as bureaucrats, legislatures, or business elites. The rate of legal change may be comparatively slower, and the locus of legal change less court-centered, than in decentralized systems.

We again acknowledge the affinities between our framework for understanding legal systems and the canonical taxonomy of common-law and

civil-law systems, particularly as they relate to the role of the courts as agents of legal change. But we now see that the variation in the role of the courts in countries around the world is a function of deeper structural differences in the way demand for legal governance is transmitted through a given system. And our framework suggests that not all forms of legal change will have identical effects on a legal system. In particular, changes that alter the incentives of those who operate the system such as procedural changes lowering the cost of filing suit or providing attorneys with greater incentives to use the courts have the potential to gradually alter the underlying characteristics of a legal system by changing the avenues of contestation available to law's consumers.

Legal Transplants

Legal transplants are perhaps the most common form of legal development around the world (see Watson 1993).[7] Transplants are so common in part because, as Friedman (1969, 46) put it, leaders believe that "modern law must come from the advanced countries and that it is a kind of capital good or technology that cannot be locally supplied." The institutional autopsies also highlighted the borrowing of law from other countries as a prominent form of legal change. With the notable exception of the United States, recent legal development in each of the countries we have examined involves the transplantation[8] of foreign law to address a perceived problem or institutional weakness in the domestic system.[9] Moreover, as our discussion of the E.U. Takeover Directive in connection with the Mannesmann case suggests, another prominent form of legal change in the past decade is the effort at harmonization, explicitly designed to produce a common legal framework for a given economic activity across many countries.

As we have noted, a line of scholarship claims that the origin of a country's legal system—the legal family to which it belongs—is a significant determinant of the *effectiveness* of its legal institutions. Countries belonging to the English common-law family are found to have more effective investor protections than countries belonging to the French and German civil-law family, and members of the Scandinavian civil-law family fall somewhere in between. Membership in a legal family is also found to affect enforcement. La Porta et al. (1998) find that after controlling for GDP per capita (which is highly correlated with enforcement), French and German civil-law countries have poorer enforcement than English common-law countries, while enforcement in Scandinavian countries is similar to that in the latter.[10] These findings suggest that where a country's law comes from may

affect economic growth by leading to relatively stronger or weaker legal institutions.

These empirical results are fascinating, but they contradict the real-world experience of law reformers. The two major "law and development" movements in the twentieth century, the first taking place after World War II and the second after the collapse of the Soviet Union and its satellite states in Eastern Europe, reached exactly the opposite conclusion. They left little doubt that changes in formal law have little impact on the effectiveness of legal institutions. Indeed, the experience so dispirited members of the first movement that they publicly declared it a failure (Trubek and Galanter 1974). The second movement seems to have fared little better, though perhaps it is too early to reach a final judgment. Far from suggesting that legal rules from the most effective legal systems can be imported to jump-start lagging economies, these experiences, like the studies by Hausman et al. (2005) and our own research discussed in chapter 1, suggest that over time there is no meaningful relation between economic growth and the purely formal attributes of a country's legal system, including the legal family to which it belongs.

Many commentators have suggested that legal transplants that do not comport with local culture will fail (for example, Frankel 1995; Smith 1993; Montesquieu 1977). But this observation is too broad to be of much predictive value, particularly because the open-ended concept of "culture" opens a Pandora's box of interpretive nightmares.

A demand-adaptation theory of legal change is a more promising way to approach the question of whether effective legal rules can be imported. Drawing on our prior work with others (Berkowitz, Pistor, and Richard 2003; Kanda and Milhaupt 2003), we sketch a theory of legal transplants that explains the conditions under which legal transplants will be effective as a mode of legal change, and, conversely, when transplants will fail to play a meaningful role in the host country's legal system—a phenomenon we have previously labeled the "transplant effect" (Berkowitz, Pistor, and Richard 2003; Milhaupt 2001). Consistent with the overall conceptual approach we employ in this book, our theory is that the nature of legal demand for the transplanted law and the process by which it is incorporated into the host country's institutional structure significantly affect whether and how the transplant will function. The findings of the economic studies clash with real-world experience of law reform because the studies make no attempt to differentiate between countries that developed their legal systems internally from those that received their law by way of legal

transplantation. Consistent with the predisposition of economists to view law as exogenous to markets and to remain indifferent to the actual mechanics of lawmaking, these studies implicitly assume that the *process* of legal development is irrelevant to the effectiveness of a given legal system. Yet this is the key to understanding the transplant phenomenon.

We begin by asking why this is such a common form of legal change. The motivation for transplants is important because it affects demand. First and most obvious, a legal transplant is a cheap, quick, and potentially fruitful source of new law. Learning effects associated with the rule in the home country can potentially be utilized in the host country, providing a "market-tested" product to local consumers of law. Developing countries or developed countries that are experiencing a given economic phenomenon of first impression (such as hostile acquisitions) would be remiss if they did *not* piggyback on other countries' experience in devising legal responses to similar phenomena. This use of foreign law is the closest analogue to technology transfer, and we refer to this as the "practical utility" motivation for transplantation.

Second, legal transplantation has often followed colonization or military conquest as the new regime seeks to transform the governance structure of the colony or occupied territory. We will call this the "political" motivation for legal transplants, and it is commonly associated with sweeping, system-wide legal transplants of the kind experienced by Korea under Japanese occupation, Latin America under Spanish rule, or the French colonies in Africa.[11] Note that the political motivation accounts for most of the groupings of countries into legal families in the canonical taxonomy used by the law and finance scholarship. We return to this point below, because it helps explain the mismatch between the economists' findings and the real-world results of legal reform.

Third, as we suggested in the introduction, law has an expressive function. Conscious of the signaling power of law and legal reform, political actors and members of the legal community may use foreign as opposed to home-grown law to signal some desired quality of their governance. Two examples from Japan at different historical moments illustrate the point. At the turn of the twentieth century, Meiji leaders enacted virtually verbatim translations of European legal codes. Whatever the practical utility of this strategy,[12] it was also motivated to a significant degree by a desire to escape the threat of Western domination—which had become manifest in the Unequal Treaties imposed on Japan—by showing that Japan was a modern, advanced nation on a par with the West. More than a century

later, Japan borrowed Delaware judicial standards for takeovers in part to signal adherence to "global standards."[13] Signaling has always been and remains a powerful motivation for legal transplants.

The final reason for the prevalence of transplants is not motivation but shortcomings in human cognition and decision making: legal rules are sometimes borrowed in haste and without adequate preparation or familiarity ("blind copying"). For example, in the middle of the nineteenth century, Colombia enacted virtually all eleven hundred articles of the Spanish Commercial Code of 1829 without change (Means 1980). More recently, observers of the Eastern European countries, which joined the European Union in 2004, have likened the legal reforms undertaken prior to their accession to a "legislative tornado." European directives in principle permit lawmakers substantial discretion in formulating domestic implementing legislation. Given the sheer magnitude of the legal change that was required, however, and the lack of capacity on the ground, many countries simply copied law "by the meter" from other member states (Pistor 2004).

The motivation or reason for a legal transplant is important because it affects the conduct of the legal community that subsequently interprets and enforces the law. The second step of our theory is that the performance of a legal transplant depends on the extent to which the changes are aligned with the conduct of lawyers, judges, and bureaucrats in applying and enforcing the law.[14] And just as with a home-grown law, enforcement conduct is deeply affected by demand for the legal transplant among the relevant constituencies that support the current system of governance. Our theory is that a legal transplant fits the host jurisdiction if it is sufficiently responsive to demand that the legal community integrates the transplanted law into the surrounding legal system. We call this type of integration "micro-fit."[15] For example, for the transplantation of a protective legal rule from a decentralized legal system to a more coordinative system, the relevant issues include whether there are mechanisms in place to enforce the new rule. Do plaintiffs and lawyers have incentives to bring suits that make use of the new rule? Are judges familiar with the concept or doctrine underlying it? Are they inclined to side with the normative implications of the legal change? Demand sufficient to motivate this integrative activity by the local legal community is more likely to exist if the transplanted rule complements the political economy of the host country. We call complementarity between the transplant and the political economy "macro-fit."[16] Here the important issues are whether the foreign legal rule responds to an actual governance gap in the host country's institutional structure that is not filled

by nonlegal mechanisms and whether the rule is likely to be used, given the local interest group structure.

This theory generates two main predictions: First, all else being equal, internally developed legal systems will function more effectively in support of markets than will legal systems developed via transplantation. The reason is that internal development typically occurs via the rolling relation between legal and market development we described in chapter 2. By definition, law developed in this manner is at least broadly responsive to demand and consistent with the political economy in which it was enacted. Moreover, the legal community will not only be familiar with the rule from its inception but may have played a large role in its production. As such, complementarities between the new rule and the surrounding infrastructure are typically built into the enactment and enforcement processes. This does not mean, of course, that all internally developed law is optimal for the circumstances or that every internally developed law is superior to each possible foreign alternative. It simply means that legal systems developed internally enjoy important advantages over transplanted legal systems.

Second, legal systems developed via transplantation—those of most of the world—will vary in their effectiveness depending in significant part on how well the local community adapts the law to local circumstances. Among the important variables are the motivation for the transplant (with practical necessity being the most conductive to adaptation), whether demand by relevant constituencies for the law exists (or conversely, whether nonlegal substitutes exist that would diminish demand), whether the legal community is familiar with the transplanted law, and whether the law is broadly consistent with the political economy of the host country, such that it is compatible with other governance mechanisms at work in society.

In separate research projects, we have found evidence consistent with these predictions. Berkowitz et al. (2003) find that the way in which a law is transplanted is a more important determinant of a legal system's effectiveness than whether the legal system was supplied by a particular family. Note again that the categorizations used by the economists are based entirely on the first wave of legal transplantation that took place at the end of the nineteenth century, which was principally motivated by politics and symbolism. It is thus natural to expect less familiarity and adaptation by local communities with respect to these transplants.

Using qualitative analysis of a single rule, Kanda and Milhaupt (2003) reach conclusions highly consistent with the cross-country empirical analysis of Berkowitz et al. (2003). They analyze the transplantation of the duty

of loyalty principle into Japanese corporate law as part of the amendments to the Commercial Code under the American-led occupation in 1950. The transplanted duty of loyalty played virtually no role in the governance of directors' conduct during the period of high economic growth, because it had poor micro- and macro-fit with Japan's legal system and political economy at that time. Enforcement mechanisms were not well developed to encourage the use of litigation to enforce the rule. And a high-growth economy with little labor mobility greatly reduced managerial incentives to engage in transactions that posed conflicts of interest in violation of the rule. But as lawyers and judges gained familiarity with the duty of loyalty standard, as procedural obstacles to its enforcement in the legal system were removed, and as the economic institutions of Japan began to break down in the late 1980s, opening new opportunities and incentives for expropriation of firm assets by insiders, the duty of loyalty came to play a role in the governance of Japanese firms.

The larger lessons from both studies are remarkably similar: local demand and adaptation appear to be the keys to effective use of legal transplants. Put differently, transplants play a meaningful role in a legal system when, but only when, they become part of the rolling relation between law and markets, with local constituencies playing a critical role in mediating between the two.

Convergence

What insights might a demand-adaptation approach to legal change offer for the question of whether legal systems and corporate governance structures are converging on an Anglo-American shareholder-oriented model? The convergence question has preoccupied scholars of comparative corporate governance for some time,[17] yet the debate has devolved to essentially two positions. On one side is the strong-form convergence theory rooted in evolutionary concepts advanced by Hansmann and Kraakmann (2001), discussed above. On the other, Bebchuk and Roe (1999) argue that path dependencies based on efficiencies and rent-seeking will slow corporate change and block convergence.

Certainly the forces for convergence of legal rules have never been more powerful: foreign institutional investors seek a common set of rules to govern their capital investments. Information technology has made knowledge of foreign law accessible instantly and at low cost. International organizations such as the World Bank and the IMF have pursued policy programs that require or encourage the adoption of a standard package of legal

reforms. Delaware state officials travel the globe promoting the benefits and low cost of incorporation in Delaware, putting pressure on other jurisdictions to mimic features of Delaware corporate law. Scholarship has contributed to these homogenizing influences as the investor protection index of La Porta et al. has become something of a benchmark in the evaluation of corporate law quality around the world.[18] Now arcana that are of debatable real-world significance, such as cumulative voting for directors,[19] are dutifully emulated by law reformers around the world. The cumulative effect of these developments is the increasing commodification of law, and there is little question that laws governing economic organizations and activities in major countries are taking on similar outward characteristics, a phenomenon that has come to be known as formal convergence (see Gilson 2001).

Nothing in our analysis, however, suggests that formal convergence per se is meaningful to the governance of markets beyond potential signaling and credibility enhancement functions. We suspect, for example, that portions of the Sarbanes-Oxley Act have proved to be attractive transplants in some other countries—despite the fact that it was enacted in response to a set of governance challenges distinctly rooted in late twentieth-century U.S. capitalism—for the same reason the law was enacted in the United States: because it signals governmental seriousness about corporate governance and white-collar crime. Even the signaling and credibility enhancement effects of formal convergence will vary, depending on the extent to which a given country has in the past actually used and enforced transplanted law as opposed to simply enacting it. The protective and coordinating functions of law may be very difficult to perform through legal transplants because they are deeply connected to home-country power relations and institutions. Assuming that the transplanted law is integrated and enforced, the introduction of laws from a protective, decentralized system such as that of the U.S. into legal systems traditionally characterized by their centralized and coordinative features, such as those of Korea, Japan, and Germany—the trend in the world today—may fundamentally alter the character of the latter systems. This may explain, for example, the staunch resistance around the world to U.S.-style mechanisms for bringing class-action suits as a device for shareholder protection.

The dichotomous convergence debate, which depicts systems as either converging on a U.S.-style shareholder-oriented model or being blocked from that trajectory owing to path-dependence, masks important features of the actual process of legal and market reform revealed in our institutional autopsies. A more informative analytical construct for thinking

about how foreign legal knowledge is incorporated into local regimes is *institution telescoping and stacking.* In practice, the home country's experience with the formation, interpretation, and enforcement of the rule—that is, massive amounts of implicit knowledge—is "telescoped" when the host country transplants a law. In the process, a portion (perhaps most) of this implicit knowledge is left behind. The law is presented as a convenient or politically palatable package and stacked atop existing institutions in the host country. Only through repeated strategic and adaptive responses by local actors can the transplanted rule and the preexisting institutions eventually be welded together into something new and functional. Telescoping and stacking may be mechanisms of institutional convergence, but that is not the inevitable outcome of the process. Legal transplants contain a Jurassic Park quality:[20] mutations are commonplace. Recall that a legal intervention, from whatever source, is likely to elicit strategic and adaptive responses by those affected by the new rule. Thus, the set of possible responses to a legal transplant is not binary rejection or acceptance but an unpredictable range of actions based on strategic maneuvering whose precise contours are difficult to anticipate.

This analysis suggests that a potentially important force for the convergence of legal systems lies somewhere no one has noticed: change in the education and structure of the legal profession around the world. A demand-adaptation analysis suggests that familiarity of local legal communities with transplanted rules is a key determinant of whether the rules will be used in the host system as governance mechanisms. The increasing influence of the United States in the market for graduate legal education has significant implications for the transplantation phenomenon. Each year, thousands of foreign graduate students (virtually all of whom are already lawyers, judges, prosecutors, government officials, in-house providers of corporate legal services, or legal academics) study law in the United States. In 2004–5, for example, almost one thousand foreign students were enrolled in graduate LLM degree programs at the top ten American law schools alone.[21] This represents a major expansion in such training over the course of the past two decades. Equally important, the U.S. model of legal education has become highly influential in other parts of the world. Japan recently introduced major changes to its system of legal education explicitly patterned after the U.S. system. Along with these reforms, the size of the legal profession is being expanded in a direct response to greater demand for legal services in a society that now relies more heavily on legal governance than during Japan's postwar period of high growth. Korea has just embarked on similar reforms for precisely the same reasons.

An ever-growing number of legal professionals around the world who are intensely familiar with U.S. legal doctrines, practices, and theories implies an increasingly powerful U.S. influence on legal systems around the world. Network effects similar to those that have helped make English a global language or Delaware the predominant corporate law jurisdiction in the United States could take hold: regardless of the intrinsic merits of the U.S. legal system vis-à-vis any other, the greater the number of legal professionals who are expert in U.S. law, the greater the benefits of learning and adopting U.S. law in one's home country. These "network externalities" accrue from many sources. To name only two, the spread of U.S. law enhances the ability of far-flung legal professionals to speak a common legal language in transactions as well as adversarial settings. And this expanding base increases the incentives of parties all over the world to select U.S. law as the governing law, conferring a benefit on those equipped to provide expert advice on that law. As these network effects proliferate, local legal communities trained in U.S. law schools will constitute a mechanism of demand for and adaptation of U.S. legal transplants.[22]

This influence of U.S. law may be felt most acutely in transactional work on behalf of global market players. As such, it may be relatively limited in its impact on the structure of foreign legal systems, although there is evidence that thorough exposure to the U.S. legal system changes the way foreign legal professionals view their own legal systems and law-making processes.[23] Legislative law-making processes, by contrast, may be particularly resistant to change. Indeed, as our analysis of countries from Germany to China suggests, lawmakers appear to be acutely aware that the decentralization of legal governance by way of encouraging decentralized law enforcement may alter the legal systems and affect the ability of other agents to coordinate socially or politically desirable outcomes. Moreover, the diffusion of legal mechanisms borrowed from one system may not necessarily produce the same outcome everywhere. Although it is but a single example, adoption of the poison pill defense in Japan is powerfully suggestive of this phenomenon. In form it looks familiar to a lawyer trained in the U.S. system, but the ramifications of the transplantation are by no means certain or predictable. In other words, as others have suggested before, "looks can be deceiving,"[24] not only with regard to the contents of substantive legal rules, but also as to the meaning and usage of procedural enforcement devices.

The larger point is that if the modes of legal governance should converge over time (a proposition for which we have at best mixed evidence at present), this does not predict convergence in outcomes. Indeed, the

creeping decentralization of legal governance we appear to be witnessing in many countries may make legal governance more responsive to local circumstances and thus promote further diversification.

Legal Standardization

We suggested above that the evolutionary approach to legal change spurs harmonization efforts and the standardization of best practices as mechanisms of legal and economic development. The expectation is that standardization will accelerate the process of legal convergence, with the dual benefit of reducing transaction costs and improving the quality of legal institutions in countries whose institutions are less well developed. Given the realities of law and law production that we have emphasized, however, legal harmonization has a weak theoretical basis as good policy. Instead of improving domestic legal institutions, standardization may undermine the development of effective legal systems. The reason for this can be found in two essential features of legal systems. The first is the interdependence of legal rules, concepts, and doctrines. Few rules can be understood without reference to other legal doctrines or concepts. The second is the fact that legal systems (as distinct from legal rules) include the people who interpret, apply, and enforce the rules. The understanding of a rule by the legal profession is integral to its operation and enforcement. In order for a rule to be standardized, there must be multinational agreement about the basic concepts behind the rule, and those concepts must be shared by diverse populations of legal professionals.

In order to accomplish this formidable task, those involved in legal harmonization efforts typically resort to one of two strategies: the lowest-common-denominator approach or a synthetic approach (Pistor 2002). In the lowest-common-denominator approach, the minimum standard in force among the relevant countries is applied to all of them. The synthetic approach is to create a new legal concept that is based on comparative research but is not actually in force anywhere, and to incorporate it into a standardized rule. Both approaches represent a compromise between the desire to reduce transaction costs and improve governance institutions across a range of countries and the reality of distinct preexisting legal systems in those countries.

But these approaches to standardization may actually undermine the goal of improving governance in countries with less well-developed institutions. In order to be effective, laws need local constituencies with an interest in and understanding of the laws. This is a prerequisite for new

law—whether home-grown or transplanted from abroad—to become part of the continuous process of legal and market change, without which the law will remain largely irrelevant as a governance device. Yet the standardization of best practices or "higher-quality" law as actually implemented may replace a Schumpeterian rolling relation between markets and law with an idealized conception of law unfamiliar to local constituencies. Thus, standardization and legal harmonization, far from being means for building effective legal systems around the world, are to be approached with considerable caution.

Conclusion

Our analysis suggests that law mediates changes in governance. Law stipulates the normative goals of governance by emphasizing the rights and interests of different constituencies. By means of procedural devices, law allocates or denies these constituencies the right to enforce their interests against others and determines the extent and form of their participation in lawmaking and enforcement. Law not only responds to demand but also shapes demand by serving as a focal point for strategic and adaptive responses among those who enforce and are subject to it. The signaling function of law is important in this regard. Some legal reforms, whether by altering substantive or procedural rights or simply by sending certain signals may trigger a dynamic process of change that helps alter the character of a legal system in important ways. This quality of law, coupled with the contestability of a legal system, opens the possibility that legal reform can at times escape the twin traps of public choice–based capture and path-dependence. Our institutional autopsies suggest that countries do not remain in legal stasis. Both the degree to which economic systems rely on legal governance and the nature of legal governance in a given system can change significantly over time.

ELEVEN

Conclusion

We began the book by noting that the quest to link economic success with particular features of a legal system has attracted the attention of prominent scholars for more than a century. We hope that our book has made several contributions to this long line of debate. We have taken seriously George Fletcher's admonition (Fletcher 1998, 690) that comparative law should be a "subversive" discipline in its attempt to "understand[ ] the way in which law develops and functions in legal cultures other than our own." Our "subversive" goal has been to challenge many aspects of the prevailing view of the way in which law supports markets—not only in faraway legal systems but in the United States, the implicit paradigm of "good law" against which many legal systems are compared today.

Most fundamentally, we have argued that it is time for new thinking about legal systems and their relation to markets. The first step is the realization that law should not be viewed as fixed but as fluid; a rolling relation, not an endowment. To this end, we have urged a new approach for analyzing legal systems focusing on their organization, the functions they perform, and their relation to the political economy. We have emphasized the need to delve deeply into a given country's *process* of lawmaking and law enforcement, as well as the *demand* for law by market actors and the mechanisms by which law changes. One of the book's major arguments is that commentators should pay less attention to the origins and formal characteristics of legal systems and focus instead on how legal systems change. We have developed a demand-adaptation theory of legal change, which has allowed us to identify pressure points within legal systems with the potential to trigger deeper legal change than legal-origin theories might predict.

We do not dispute the fact that there are affinities between the organization and function of legal systems as analyzed here and the legal-origin approach as explicated in the law and finance literature. The most decentralized and protective system in our matrix is the United States, which also happens to be a common-law country. With the exception of Singapore, the coordinative legal systems in our study are all of civil origin. But there is less overlap between the two analytical constructs than meets the eye. Whereas legal origin analysis places countries into inert historical categories and emphasizes seemingly fixed characteristics of legal systems, our focus on organization, function, and demand opens a more dynamic window onto analysis of legal systems.

Several key conclusions emerge from our study. First, as a historical matter, no single type of legal system is uniquely associated with economic success. Indeed, the countries examined in our book—all of which, with the exception of Russia,[1] qualify as economic success stories—display a wide array of legal characteristics. Pushing the conclusion further, we have seen that in several of the countries economic development preceded a "rule of law" as that term is widely understood and discussed in the literature today. Among countries at roughly equivalent stages of advanced economic development such as the United States, Germany, and Japan, legal systems vary substantially in the process of lawmaking and law enforcement. The structure of the legal professions and their respective roles in the legal system vary significantly among the three countries as well.

Our analysis has shown that even in the U.S. legal system, which some may view as the one that most closely approaches the rule-of-law ideal, vast proliferation of protections and enforcement agents creates complexities and uncertainties that are in considerable tension with the ideal of a predictable, efficient legal system as a foundation for economic activity. Ironically, Weber himself would probably not have been surprised by this conclusion. In his day he struggled to explain England's leadership among the industrializing countries of the West despite having a legal system that in many ways defied his criteria for rationality—what is often referred to as the "England problem" in Weber's work. The lesson we draw from the tension between the Weberian rule-of-law ideal and the actual operation of law in the most successful capitalist countries both in Weber's time and today is that the rule-of-law concept is too general to provide much guidance on the construction or analysis of real-world legal systems. This becomes clear if we return to the issue of property rights protections, which looms so large in collective thinking about law and development. Although universally recognized as the key role for law in support of markets, protection of

property rights is not self-defining or self-enforcing. Which rights receive protections, by whom are they enforceable, and how? Who benefits from a given assignment of property rights, and who is disadvantaged? How are new forms of property allocated and protected? Different countries have provided very different answers to these questions. In reality, to say that property rights protection is the foundation of economic development is to say very little about the characteristics of a legal system that is conducive to investment and growth.

The diversity of viable legal supports for markets and the existence of an array of nonlegal supports for market activity is not cause for discouragement but rather grounds for optimism. As a historical matter, we have seen that centralized, coordinative legal systems as well as decentralized, protective legal systems are capable of supporting sustained economic growth. Law can support markets in a variety of crucial ways—not only by providing property rights protections but also by coordinating market actors, sending signals to the consumers and enforcers of law, and enhancing the credibility of government policy. We have seen that the functions law plays in support of markets differs across countries, markets, and stages of development. The process by which markets interact with law, examined carefully across diverse societies as we have done, suggests that each country reaches its own balance between legal governance and its other market and political institutions. Our analysis suggests that many high-growth economies in the postwar period have gotten by with less (or at least different) law than the United States.

An important point follows from this line of analysis: the *benchmarking* problem merits much more attention than it has received in the literature. By this we mean the use of a specific legal rule or procedure from one system as a benchmark against which to measure the quality of other legal systems. The system typically held up as a benchmark in the past decade has been that of the United States. It is now quite common for corporate law and governance scholars from other countries, for example, to frame their entire analysis of their home country's institutional environment as if U.S. law provided a standard against which the quality of their own laws and enforcement institutions should be measured. Often, this exercise is conducted with minimal acknowledgment that the governance problems in the system for which legal solutions are sought differ significantly from those in the United States, even if a common label such as "agency problem" is applied in both settings. We have shown that on a variety of dimensions the United States is an outlier in its use of law. The U.S. legal system is highly decentralized, extremely demand-driven, and highly adaptable but

also highly complex, unpredictable, and not particularly well suited to achieving swift, coordinated solutions to governance problems. It is thus not obvious that legal solutions developed in the United States should figure so centrally in reforms designed to address governance problems faced elsewhere. However well intentioned, the intense focus on U.S. legal approaches may lead to a poverty of imagination in seeking solutions to other countries' governance problems.

The World Bank appears to be coming around to this conclusion as well. A recent publication surveying lessons that it drew from the reforms of the 1990s concludes: "[I]f solutions must be found in specific-country contexts, rather than applied from blueprints, those who advise or finance developing countries will need more humility in their approaches, implying more openness on the range of solutions possible, more empathy with the country's perspective, and more inquisitiveness in assessing the costs and benefits of different possible solutions" (World Bank 2006, 26).

To say that no single legal system is best suited for economic success, however, is not to throw up our hands in despair. Although present in varying degrees, there are certain features common to all of the legal systems we have studied in this book, with the exception of modern-day Russia. Successful legal systems for market economies must perform market-supporting functions while being flexible enough to respond to market shifts. This tension between stasis and change is achieved, in our terms, when a legal system is contestable rather than monopolized for the protection of incumbents. All legal systems struggle with the rivalry for protection between incumbents and newcomers, but successful legal systems manage this balance over time, either by giving newcomers extensive rights to challenge existing rules and doctrines, as in the United States, or by mediating competing interests at the state level and leaving the door open a crack to legal challenge by outsiders, as is done in most European and Asian legal systems associated with market economies.

Successful legal systems distinguish themselves by their institutional capacity to adapt to new market realities and to shifts in demand for legal governance resulting from new social or economic phenomena. This does not mean that effective legal solutions to new problems will always be generated or that the laws produced will always be optimal from an efficiency standpoint. It simply means that the legal system rolls with the market and provides at least a backdrop for adaptation to emerging governance problems. Effective legal governance is an ongoing institutional inclination or state of being, not a static point or fixed endowment that depends on a checklist of formal legal rules or enforcement institutions. From this

perspective, the notion of an effective legal system for economic growth as a neutral third-party agent of contract enforcement and property rights protection (North 1990) misses the mark.

We began sketching our analytical framework with the simple insight that law and markets respond to each other in highly iterative fashion. We ended chapter 10 with some conjectures about the process of legal change, particularly in an increasingly globalizing world. A major topic for future research is the way the processes of lawmaking and law enforcement are being affected by globalization. Viewed at close range and across several systems simultaneously, globalization appears to be forcing legal systems built on the centralized, coordinative model to become more decentralized and protective in their orientation. The mechanism of change in this direction has often been a transaction or series of encounters pitting a market newcomer (sometimes foreign, sometimes domestic) against an incumbent. The newcomer is less respectful of existing rules for market activity (whether legal or nonlegal), forcing both private- and public-sector actors to reevaluate the rule system or to adapt their conduct to the new state of play. The rise of private equity may be the latest example of this process of creative legal destruction. But we lack detailed studies of how various actors in the law-making and enforcement processes are responding to this phenomenon and how it is affecting the production and enforcement of law.

As we have noted at various points in the book, the process of globalization as it affects legal systems means that not only newcomers but also incumbents have access to the newly built legal machinery. This means that law reform contains a great irony that is not fully appreciated: newfound forms of legality can be used to block as well as facilitate institutional and market change.

Moreover, and equally important, key legal actors such as the courts have not necessarily themselves undergone globalization to the same extent as have other parts of the legal system, such as practicing lawyers or the formal law on the books. So several of the countries we have studied—and, we suspect, many others beyond the scope of the book—are currently caught in a twilight zone of legal governance. Statutory law has been modernized, new actors have appeared in the markets and in the courts, and the legal machinery is being put to use like never before, but the outcomes are rather contradictory and unpredictable, sometimes suggesting openness to new forms of legality in the governance of market relations and sometimes displaying rather xenophobic tendencies.[2] The recent experiences of Japan and Korea that we have examined epitomize in many ways the

ambiguity and contradictions in the globalization of legal governance to which we have just adverted. But much more work needs to be done if we are to understand the effects of global flows of capital, information, technology, managerial talent, and other factors of production on domestic legal systems.

In methodological terms, we argued that focusing on a moment of stress is highly revealing of the underlying dynamics of a complex system, permitting unique insights into its vulnerabilities and its propensity for change. We have applied this methodology only with respect to corporate governance crises, but we believe that it could prove useful in understanding other features of a country's governance system as well. For example, the institutional autopsy might prove revealing in the context of financial crises, labor unrest, or even environmental catastrophes. We hope the book might inspire further studies of breakdowns of governance in other realms as a means of understanding complex institutional relationships, stasis, and transition in the political economy.

As we noted at the outset, our instinct was to see a complex world where many have seen straight lines of causation. The complexity of the subject matter places great demands on the reader as well as the investigator. We hope that this book has shown that complex systems can be examined on their own terms—as messy and to some extent unpredictable—without dispensing with an analytical framework that exposes dead ends in the prevailing wisdom and brings a new order to our collective thinking about a fascinating and important topic. Of course, no single work can provide definitive answers to the big questions about the relation between legal systems and economic development that have occupied generations of scholars. But we hope that this book has altered, if modestly, the way these questions are approached.