"Law and Finance": Inaccurate, Incomplete, and Important

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"On the face of it, shareholder value is the dumbest idea in the world. Shareholder value is a result, not a strategy. . . . Your main constituents are your employees, your customers and your products."[1]

– Jack Welch, former CEO of General Electric

I. INTRODUCTION

While virtually all scholars of corporate governance agree that national differences exist in corporate governance practices and their efficacy, debate continues regarding the relevant dimensions of difference and how to best explain them. In this Essay, we argue that the strong conceptual and empirical link between law and finance as proposed within the legal origins theory and fully launched in a series of articles by LLSV[2] is inaccurate, incomplete, and yet important. At the least, it is important to get a clearer view of the field such that we may better understand the broader scope of the "law-finance" relationship, particularly as the law and finance theory has had demonstrated effects on international policy developments.

A number of scholars have effectively demonstrated the key shortcomings of this theoretical and empirical unidirectional linkage from law to finance.[3] We do not need to review that literature here,

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1. Francesco Guerrera, *Welch Condemns Share Price Focus*, FIN. TIMES, March 12, 2009.

2. We use the acronym "LLSV" to refer to the four authors of the first legal origins papers, which include Rafael La Porta, Francisco Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny. *See generally* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999); Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997).

3. *See generally* Mark J. Roe, *Corporate Law's Limits,* 31 J. LEGAL STUD. 233 (2002); Mathias M. Siems, *Shareholder Protection Around the World ("Leximetric II")*, 33 DEL. J.

but we find it convincing. And, in response to some of their critics, La Porta, Lopez-de-Silanes, and Shleifer have rectified some of their strong and prescriptive former claims.[4] In this Essay, we discuss in Part II what we have learned from this agitated debate with so many policy and real life ramifications, why it is important to conceptualize a larger and more complex picture of the proposed law-finance causality, what we can learn from existing research on comparative systems in social science, and what we need to study next in the field of research of legal systems and economic sociology. In Part III, we discuss why it is important to get "law and finance" right.

II. THE VIEW FROM ECONOMIC SOCIOLOGY: LAW AS A PARTIAL VIEW

A. Complementarities Matter

One could take multiple routes to illustrate the principle that looking simply at the characteristics of the legal system to explain economic outcomes is *incomplete*. One limitation is, perhaps, the methodological tools we use to analyze these questions. For instance, it seems rather narrow to summarize the advanced industrialized countries into two stylized systems: liberal market economies and coordinated market economies, which happen to correspond nicely to the common and civil law dichotomy. Perhaps the explanation for simplicity is the methodological limitations we face in comparative corporate governance research and comparative law—namely, a large number of potential explanatory variables and a small number of cases. Kogut and Ragin put it well when discussing the limited diversity within varieties of capitalism and their empirical rejection of the hypothesis of a direct relationship between rule of law and financial development. They state that "[c]ontrary to silver bullet theories, many studies recognize that economic systems are varied and that there is more than one path to wealth."[5]

CORP. L. 111 (2008); Mathias M. Siems, Simon Deakin & Priya Lele, *The Evolution of Labour Law: Calibrating and Comparing Regulatory Regimes*, 146 INT'L LAB. REV. 133 (2007).

4. *See generally* Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Economic Consequences of Legal Origins*, 46 J. ECON. LITERATURE 285 (2008).

5. Bruce Kogut & Charles Ragin, *Exploring Complexity When Diversity is Limited: Institutional Complementarity in Theories of Rule of Law and National Systems Revisited*, 3 EUR. MGMT. REV. 44, 50 (2006).

Organizations are widely conceived as complex systems of interdependent factors, but empirical methodology often poorly reflects such interdependence. For example, standard linear models, such as regression analysis, treat variables as competing to explain variation in the outcome rather than focusing on how causes may combine in specific *cases* to create outcomes. Meanwhile, case studies have an important tradition in organizational research, but such studies face the challenge of generalizing across cases or using cases effectively to better "contextualize" the boundary conditions of existing theories. Recently, new innovations in comparative research methods have been developed and applied to the comparative study of corporate governance at the organizational or national level. In particular, a number of newer small-N and set-theoretic methods, such as Qualitative Comparative Analysis ("QCA"), have been applied to cross-national data (where N is small)[6] or to organizational analysis where causation is complex and there is more than one path to an outcome.[7]

Jackson and Aguilera have used this comparative methodology to study why the twenty-two OECD[8] countries used in their study show such diverse ownership structures and how these ownership structures have shifted over time—from the 1990s to the 2000s.[9] They were able to systematically explore various existing explanatory factors *in conjunction* (law, financial systems, labor markets, political system, board composition, etc.).[10] They demonstrate, for example, that law is necessary but not sufficient to explain economic organization.[11] More specifically, their analysis rejects the sweeping conclusions drawn from most of LLSV's studies.[12] They show that quality of law proves necessary for ownership dispersion, at least at a

6. *See generally id.*

7. *See generally* CHARLES C. RAGIN, REDESIGNING SOCIAL INQUIRY: FUZZY SETS AND BEYOND (2008).

8. OECD stands for Organisation for Economic Co-operation and Development. The OECD is an organization of thirty countries committed to democracy and the market economy. *See* About OECD, http://www.oecd.org/pages/0,3417,en_36734052_36734103_1_1_1_1_1,00.html (last visited Jan. 11, 2010).

9. Gregory Jackson & Ruth V. Aguilera, Some Determinants of Diversity on Cross-National Corporate Ownership: A Fuzzy Sets Approach (2009) (working paper, on file with Research Institute of Economy, Trade and Industry).

10. *Id.* at 4–5.

11. *Id.* at 2, 5.

12. *Id.* at 20.

minimum threshold, but that the reverse case (concentrated ownership as a reflection of poor quality of law) is not necessarily true.[13] That is, Jackson and Aguilera show that not all cases of concentration are the result of bad law.

The need to study driving factors in conjunction to obtain a more comprehensive yet systematic understanding of relationships is also true for the political hypothesis based on Gourevitch and Shinn[14] and Roe.[15] The political factors influencing ownership structure, as discussed by Roe and Gourevitch, appear to be important, but they are missing interesting nuances if not explored in combination with other explanatory factors, such as the structure of labor forces, law, finance, etc. That is to say that strong-law and weak majoritarian institutions are sufficient but not necessary for dispersion. The main point from this research is *equifinality*, suggesting that there are multiple paths to any given outcome. For instance, if strong law is not present then there might be substitutes (strong labor and left-wing politics) to strong law that in complementarity lead to the same outcome that strong law would lead. It also suggests that there is not one best Pareto optimal solution in institutional settings or a one-model-fits-all best practice of corporate governance.

B. The Difficulty of Transplantation and the Reality of Translation

It is particularly illuminating to explore nonpure models, such as examining what happens when archetypical “Anglo-Saxon” shareholder-value-oriented practices are implemented in non-Anglo-Saxon institutional environments. Examining the transplantation of such corporate governance practices allows us to get a deeper understanding of how countries, industries, and firms are selective in their adoption of “pure” corporate governance practices and even more often how some effort is invested into translating those practices so they fit into their environment. A good illustration of the diffusion of practices is the globalization of Anglo-American institutional investors in the mid-1990s, which shocked the recipient host countries’ established norms and practices but did not manage

13. *Id.*

14. PETER A. GOUREVITCH & JAMES SHINN, POLITICAL POWER AND CORPORATE CONTROL: THE NEW GLOBAL POLITICS OF CORPORATE GOVERNANCE (2005).

15. Roe, *supra* note 3.

to fundamentally transform them. We will draw on two empirical examples to be more specific.

First, Goyer's research comparing foreign investment in France and Germany demonstrates that law and ownership structures cannot account for the disparities in the investment allocation by short-term investors in those two countries.[16] He looks at the different patterns of investment by short-term institutional investors in France and Germany and finds that for stakes above the five percent level, short-term investors are twice as likely to invest in France as compared to Germany.[17] Why? Because Germany's work councils and organized labor make it more difficult to set in motion short-term oriented strategies to extract shareholder value, while labor is less powerful in France.[18]

Second, the translations that occur with transplantation are not only ideological but also structural, as illustrated in the research by Ahmadjian and Robbins.[19] They show that the foreign (mostly U.S.) ownership of Japanese firms grew from five percent in 1990 to twenty percent in 2001; these foreign investments led to a clash of capitalism between foreign share owners and local owners (mostly banks and other local firms).[20] Foreign owners were interested in establishing shareholder-oriented (short-term) practices such as downsizing and asset divestitures.[21] Ahmadjian and Robbins are able to show that the presence of foreign capital determined the levels of downsizing and divestitures in this period in Japan—practices highly inconsistent with Japanese stakeholder capitalism and challenging traditional lifetime employment.[22] When Japanese owners maintained control, however, these shareholder-friendly practices still occurred, but at a much slower rate.[23]

16. Michel Goyer, *Capital Mobility, Varieties of Institutional Investors, and the Transforming Stability of Corporate Governance in France and Germany*, *in* BEYOND VARIETIES OF CAPITALISM: CONFLICT, CONTRADICTIONS, AND COMPLEMENTARITIES IN THE EUROPEAN ECONOMY 195 (Bob Hancké, Martin Rhodes & Mark Thatcher eds., 2007).

17. *Id*. at 205.

18. *Id*. at 206–15.

19. *See generally* Christina L. Ahmadjian & Gregory E. Robbins, *A Clash of Capitalisms: Foreign Shareholders and Corporate Restructuring in 1990s Japan*, 70 AM. SOC. REV. 451 (2005); *see also* GOUREVITCH & SHINN, *supra* note 14; Roe, *supra* note 3.

20. Ahmadjian & Robbins, *supra* note 19, at 452.

21. *Id*.

22. *Id*.

23. *Id*.

C. The Relationship of Law and Politics

Roe argues that legal institutions are a direct derivative of politics because countries have different preferences concerning the legitimacy of shareholder value.[24] If shareholder value is considered legitimate, institutions are then built to protect minority shareholders.[25] By contrast, the absence of institutional arrangements that would protect the rights and promote the interests of minority shareholders in some countries reflects the lack of legitimacy about caring only for shareholders. Thus, the question is not about the technical issue of building an efficient system of corporate law, but about the issue of whether political will exists to do so.

Roe further argues that it is simplistic to think that legal institutions which were introduced seven hundred years ago, such as the civil law code-based jurisprudence, are as important in influencing economic life as regulations that were introduced fifty years ago, such as the 1933 U.S. Glass-Steagall Act or the 1936 Italian Banking Law introduced in reaction to the 1930s financial crisis and the Second World War.[26] We find these arguments persuasive.

D. Ownership Structures—Dispersed Is Not Necessarily Optimal

The implicit assumption of the legal origins theory is that dispersed ownership within corporations is the ownership structure most likely to produce the best economic outcomes. Yet, most firms in the world are not owned by dispersed shareholders but are firms with controlling shareholders, mainly family-owned firms or firms owned by either large institutional investors or the state.[27] Even in the United States—the archetypical Anglo-Saxon shareholder-oriented country with dispersed ownership—between 1992 and

24. Roe, *supra* note 3, at 267.

25. *Id.* at 262–63.

26. Mark J. Roe, *Juries and the Political Economy of Legal Origin*, 35 J. COMP. ECON. 294, 295–308 (2007).

27. Stijn Claessens, Simeon Djankov & Larry Lang, *Disentangling the Incentive and Entrenchment Effects of Large Shareholdings*, 57 J. FIN. 2741, 2742–44 (2000); Mara Faccio & Larry H. P. Lang, *The Ultimate Ownership of Western Corporations*, 65 J. FIN. ECON. 365, 366 (2002); Julian Franks & Colin Mayer, *Corporate Ownership and Control in the U.K., Germany, and France*, 9 J. APPLIED CORP. FIN. 30, 32–37 (1997); La Porta et al., *supra* note 4, at 287; Andrei Shleifer & Robert Vishny, *Large Shareholders and Corporate Control*, 94 J. POL. ECON. 461, 462–65 (1986).

1999, one-third of the largest firms (the Standard & Poor 500 Industrial ("S&P 500")), which accounted for eighteen percent of the S&P 500 equity stake, had family ownership control structures.[28]

The legal origins research and some finance scholars argue (sometimes quite forcefully) that continued family ownership generally leads to poor performance; hence, they recommend that a more efficient ownership structure aligning management with shareholders' interests is dispersed ownership with strong minority shareholders' protection.[29] However, the jury is still out within the corporate finance literature on whether family-owned firms perform worse—or better—than firms with nonfamily ownership. For example, Anderson and Reeb state, "[C]ontrary to the notion that family ownership is detrimental, we find stronger firm performance in family than in nonfamily firms."[30] Villalonga and Amit report similar results.[31] As argued by agency scholars, concentrated ownership can be advantageous to minimize managerial expropriation because it combines ownership and control.[32] Of course, as uncovered by Faccio et al., in the case of East Asian markets or the *Adelphia U.S.* case, this monitoring will only work when there are transparent financial markets and nonfraudulent accounting, respectively.[33]

Another dimension of corporate ownership to be understood is not so much the type of owner but how much they own (i.e., concentration). We do not equate the owner's identity with the firm's responsibility as one did fifty years ago with the Fords, the DuPonts, and the Rockefellers of Chandler's multidivisional firms, probably because firms have become so large and because there is a mix of ownership (as in the United States). It is also arguable that U.S. corporate governance has shifted from "managerial capitalism" with dispersed retail ownership where managers made the key

28. Ronald C. Anderson & David M. Reeb, *Founding-Family Ownership and Firm Performance: Evidence from the S&P 500*, 58 J. FIN. 1301, 1302 (2003).

29. *See generally* RANDALL MORCK, CONCENTRATED CORPORATE OWNERSHIP (2000).

30. Anderson & Reeb, *supra* note 28, at 1303.

31. Belen Villalonga & Raphael Amit, *How Do Family Ownership, Control and Management Affect Firm Value?*, 80 J. FIN. ECON. 385 (2006).

32. Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155 (1985).

33. Mara Faccio, Larry H. P. Lang & Leslie Young, *Dividends and Expropriation*, 91 AM. ECON. REV. 54, 72 (2001).

decisions, to "investor capitalism."[34] As Davis argues in his book, *Managed by Markets: How Finance Reshaped America*, the arrival of postindustrial society, predicted by Daniel Bell, in which the great majority of jobs are in the service sector, accompanied by a weaker relationship between employers and employees and a shift in pension financing from defined benefit company pensions to "defined contribution plans" (401(k)), has triggered the massive growth of the mutual fund industry.[35] Mutual funds and other institutional investors are growing in size and ownership concentration. Davis states, "Nearly three quarters of the average Fortune 1000 corporation's shares were owned by institutional investors in 2005, with mutual funds making up the most concentrated block."[36] Yet, these portfolio shareholders show a remarkable lack of engagement ("voice") as shareholders, primarily exercising exit, having high ratios of share turnover in their portfolios, both in the Anglo-Saxon countries as well as in Europe.[37] This is explained in part because it is very expensive to express voice, and second, even very large shareholders such as Hermes in the U.K. rarely have enough control to discipline managers.[38] As a result, investor capitalism still presents the problem of potential managerial expropriation.

E. Future Research

The development of capitalism in the twenty-first century, particularly after the U.S. financial collapse and its subsequent recession, is entering a new era where there is a conflict between the increasing globalization of markets, finance, regulation, corporate activity, managers, and knowledge, and the many economic activities that are very much grounded at the state level. The state has played a much more central role in economic life in Europe and Asia until recently, either through regulation or through direct firm ownership

34. MICHAEL USEEM, INVESTOR CAPITALISM: HOW MONEY MANAGERS ARE CHANGING THE FACE OF CORPORATE AMERICA 5–8 (1997); Gerald F. Davis, *A New Finance Capitalism? Mutual Funds and Ownership Re-Concentration in the United States*, 5 EUR. MGMT. REV. 11, 13–21 (2008).

35. GERALD F. DAVIS, MANAGED BY MARKETS: HOW FINANCE RESHAPED AMERICA (2009).

36. Gerald F. Davis, *The Rise and Fall of Finance and the End of the Society of Organizations*, 23 ACAD. MGMT. PERSP. 27, 33 (2009).

37. Gregory Jackson, *A New Financial Capitalism? Explaining the Persistence of Exit over Voice in Contemporary Corporate Governance*, 5 EUR. MGMT. REV. 23, 24–25 (2008).

38. *Id.* at 24.

and strategic intervention. The state's active role in economic and social life, including welfare state provisions, has been for the most part sustained despite the strong 1990s shareholder-oriented pressures from the United States. These pressures resulted in an international hybridization process, ranging from full adoption of some practices, such as anti-trust regulation, to complete rejection of some practices such as compensation disclosure, as documented in an edited book by Morgan, Whitley and Moen,[39] and in a book by Djelic[40] on the "Americanization" of European firms, and in an article on how national culture might buffer organizational level innovation and institutional change,[41] among many others. The pattern emerging now in the United States shows a more proactive and monitoring role in the economic governance and regulatory relationship between markets and firms. This is particularly so after the government interventions in some of the largest American companies that were striving to achieve maximum shareholder value and yet now are partially or majority state-owned, such as AIG and Citigroup.

The institutional legal and economic environment has triggered movement from firms in emerging or developing countries looking to reach higher levels of legitimization in their corporate governance. For example, many firms from middle income, developing and emerging markets are listed in the New York or London Stock Exchange to prove to their stakeholders that they seek to meet the highest economic and governance standards. The movement in the other direction also occurs, when firms from the industrialized world operate in less developing or emerging markets. These firms make such a move, among other things, to take advantage of institutional arbitrage—such as weak enforcement of global environmental regulations, cheaper labor, or favorable government incentives. Both of these very common internationalization patterns expand beyond the ideas in the legal origins literature in showing that it is almost impossible to attribute economic advantages to merely one single legal or economic system when most firms operate multiple layers of legal systems and their value chain is affected differently. Today, the

39. GLENN MORGAN, RICHARD WHITLEY & ELI MOEN, CHANGING CAPITALISMS (2005).

40. MARIE-LAURE DJELIC, EXPORTING THE AMERICAN MODEL 1998).

41. Trevor Buck & Azura Shahrim, *The Translation of Corporate Governance Changes Across National Cultures: The Case of Germany*, 36 J. INT'L BUS. STUD. 42 (2005).

analogy is that firms are often born simultaneously in multiple countries (e.g., KPMG) or they are born global or born-again global, they grow in multiple countries around the world, yet they must die in one country (e.g., Lehman Brothers, Enron, Arthur Andersen).[42]

A recent trend that challenges even more directly the idea that a certain legal system is best for economic development or that legal systems are ultimately constraining development is the concept of the "New Multinationals" as suggested by Guillén and García-Cana.[43] This concept is probably the strongest robustness test to refute the hypothesis that strong country-level institutions, and particularly the legal environment, is a necessary condition to economic development. The new multinational enterprises from emerging, upper-middle income, and rich oil countries have overcome the so-called liability of foreignness in the different markets by entering developed and developing countries simultaneously from the first stages of their international expansion.[44] In this context, as suggested by Cuervo-Cazurra and Genc, new multinationals tend to possess critical political capabilities enabling them to succeed in countries with weak institutional environments and compensate for their lack of resource endowment.[45] In sum, this research in the internationalization field shows that MNEs' success, such as that of Inditex of Spain (Zara) or Haier in China, can be achieved almost irrespective of the institutional environment.

To conclude, we think that legal scholarship could benefit a great deal by drawing a bit more on research on national business systems,[46] on the comparative capitalism approach,[47] and more

42. *See generally* Jim Bell, Rod McNaughton & Stephen Young, '*Born-Again Global' Firms: An Extension to the 'Born-Global' Phenomenon*, 7 J. INT'L MGMT. 173 (2001).

43. *See generally* Mauro Guillén & Esteban García-Canal, *The American Model of the Multinational Firm and the "New" Multinationals from Emerging Economies*, 23 ACAD. MGMT. PERSP. 23 (2009).

44. *Id.* at 43.

45. Alvaro Cuervo-Cazurra & Mehmet Genc, *Transforming Disadvantages into Advantages: Developing-Country MNEs in the Least Developed Countries*, 39 J. INT'L BUS. STUD. 957, 963–66 (2008).

46. RICHARD WHITLEY, DIVERGENT CAPITALISMS: THE SOCIAL STRUCTURING AND CHANGE OF BUSINESS SYSTEMS (1999).

47. MASAHIKO AOKI, TOWARD A COMPARATIVE INSTITUTIONAL ANALYSIS (2001); RONALD DORE, STOCK MARKET CAPITALISM: WELFARE CAPITALISM: JAPAN AND GERMANY VERSUS THE ANGLO-SAXONS (2000); BOB HANCKE, MARTIN RHODES & MARK THATCHER,

historically oriented institutional analysis.[48] We also need to think more systematically about how employees contribute to the value added to the firm, from a stakeholder perspective as suggested in the U.K.-U.S. comparison[49] and from the perspective of the knowledge economy.[50] Other authors have stressed the role of employees in the finance-legal relationship by studying the political power of workers[51] or the economics of human assets.[52] This previous research shows that bringing labor into the equation helps us examine what might seem a remote link between employees, company resources, and national and global financing "machines" as Davis has shown with the securitization of mortgages into bonds and the takeoff of pension plans with the emergence of weaker and more flexible labor contracts in postindustrial America.[53]

Firms and markets coevolve, institutions change, not only at the regulatory level, but also within technological and knowledge spheres, and these processes are shaping economic life in a reciprocal and evolutionary way. Economic sociology captures and illuminates much of this coevolution; law and finance does not.

BEYOND VARIETIES OF CAPITALISM: CONFLICT, CONTRADICTIONS, AND COMPLEMENTARITIES IN THE EUROPEAN ECONOMY (2007); VARIETIES OF CAPITALISM: THE INSTITUTIONAL FOUNDATIONS OF COMPARATIVE ADVANTAGE (Peter A. Hall & David Soskice eds., 2001).

48. GOUREVITCH & SHINN, *supra* note 14; ARNDT SORGE, THE GLOBAL AND THE LOCAL: UNDERSTANDING THE DIALECTICS OF BUSINESS SYSTEMS (2005); Kathleen Thelen, *Historical Institutionalism in Comparative Politics*, 2 ANN. REV. POL. SCI. 369 (1999).

49. *See* CORPORATE GOVERNANCE AND LABOUR MANAGEMENT: AN INTERNATIONAL COMPARISON (Howard Gospel & Andrew Pendleton eds., 2009); Ruth V. Aguilera et al., *Corporate Governance and Social Responsibility: A Comparative Analysis of the U.K. and the U.S.*, 14 CORP. GOVERNANCE: AN INT'L REV. 147 (2006)

50. Peer Zumbansen, *The Evolution of the Corporation: Organization, Finance, Knowledge and Corporate Social Responsibility* (Feb. 20, 2009) (Comparative Research in Law & Political Economy (CLPE), Research Paper No. 6/2009), *available at* http://ssrn.com/abstract=1346971.

51. Marco Pagano & Paolo F. Volpin, *The Political Economy of Corporate Governance*, 95 AM. ECON. REV. 1005 (2005).

52. Margaret M. Blair, *Firm-Specific Human Capital and Theories of the Firm*, *in* EMPLOYEES AND CORPORATE GOVERNANCE 58 (Margaret M. Blair & Mark J. Roe eds., 1999); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999); Raghuram G. Rajan & Luigi Zingales, *The Governance of the New Enterprise*, *in* CORPORATE GOVERNANCE: THEORETICAL AND EMPIRICAL PERSPECTIVES 201 (Xavier Vives ed., 2000).

53. GERALD DAVIS, MANAGED BY MARKETS: HOW FINANCE RESHAPED AMERICA (2009).

III. WHY IS LLSV NONETHELESS IMPORTANT?

The above sections referred to or made the following points: first, careful longitudinal studies and studies using more accurate evaluations of the components of countries' legal systems have failed to support the central claim of LLSV—that a country's legal origin is an important exogenous determinant of its capacity for financial development.[54] That is to say, LLSV is based on an inaccurate view of the law. Second, institutional analyses and comparative political economy analyses of corporate governance arrangements with more nuanced views than those of LLSV can contribute valuable insights into the central question of the relationships between financial markets and economic development, and therefore provide a more considered view. That is to say, LLSV is based on an incomplete view of what matters for economic outcomes. Why, then, does LLSV still matter?

At least in part, LLSV matters because their original contributions—their data-rich descriptions of ownership patterns around the world—have given rise to provocative research questions and spawned engaging academic debates and comparative analyses.[55] They have established and defined the field of law and finance, and then elaborated upon it with prodigious productivity. Few academics can point to similar accomplishments. They are, quite simply, academic rock stars.

Yet, as a number of contributors to this special issue discuss,[56] LLSV matters for at least two additional reasons that go beyond academics: first, because their ideas have been adopted in international development initiatives by the World Bank as the basis for one set of its policy prescriptions for economic development in emerging markets; and second, because their ideas are indicative of, and have supported, the virtually unrelenting pressure on European countries to adopt more market-dominated systems for organizing their economic life.

54. John Armour, Simon Deakin, Viviana Mollica & Mathias Siems, *Law and Financial Development: What We Are Learning from Time-Series Evidence*, 09 BYU L. REV. (forthcoming 2009).

55. *See* La Porta et al., *supra* note 2; Shleifer & Vishny, *supra* note 2.

56. *See* Armour et. al., *supra* note 54; John Ohnesorge, *Legal Origins and the Tasks of Corporate Law in Economic Development: A Preliminary Exploration*, 09 BYU L. REV. (forthcoming 2009).

While one could think that perhaps LLSV's ideas have simply been misused in these regards, their own ten-year retrospective of their work, published in 2008, ends with a clear policy preference: "[O]ur framework suggests that the common law approach to social control of economic life performs better than the civil law approach. When markets do or can work well, it is better to support than to replace them."[57] It is because LLSV's preference for market solutions has had such powerful reverberations in global policy developments and European debate that it is important to examine their analysis in more depth.

A. LLSV and the World Bank's Doing Business Initiative

LLSV's work is consistent with and has provided intellectual support for a complex of policy prescriptions that are considered important in allowing financial markets to flourish—introducing clear property rights to facilitate exchange; protecting principles of freedom of contract; and perhaps most central in their writing, enhancing the legal protections for outside investors and outside senior creditors. As described by leading law-and-development scholar David Trubek, reform initiatives implementing these kinds of broad policy goals have been incorporated into the World Bank's rule of law initiatives over the last two decades.[58] These programs derive from the Washington Consensus: the view that promoting economic development through export-led growth, attracting foreign investment and encouraging capital market development and integration is the most effective way to alleviate poverty.[59] Between 1990 and 2005, the World Bank has therefore supported 330 "rule of law" initiatives at a cost of $2.9 billion.[60] As Professor Trubek also discussed, as the consensus over the Washington Consensus has started to dissolve, the World Bank has begun to develop a broader range of policy approaches to poverty alleviation that provides more

57. *See* La Porta et al., *supra* note 4, at 327. Replacing markets, in LLSV terms, includes civil law countries' continuing "to resort to 'policy-implementing' solutions to newly arising problems," such as "using state mandates to solve social problems, such as the thirty-five hour work-week in France," rather than adopting "market-supporting" solutions. *Id.*

58. *See* David M. Trubek, *The "Rule of Law" in Development Assistance: Past, Present, and Future*, *in* THE NEW LAW AND ECONOMIC DEVELOPMENT: A CRITICAL APPRAISAL 74 (David M. Trubek & Alvaro Santos eds., 2006).

59. *See generally* John Williamson, *A Short History of the Washington Consensus*, 15 L. & BUS. REV. AM. 7 (2009).

60. Trubek, *supra* note 58, at 74.

latitude to more directly address social and economic development efforts of a 'bottom up" nature.[61]

Based in significant part on LLSV's methodology for quantifying law, one strand of rule of law projects that is still emerging is the World Bank's Doing Business Initiative, begun in 2004.[62] That initiative is an ambitious attempt to collect information on the ease of doing business in (now) 183 countries in order to quantify and benchmark "the scope and manner of regulations that enhance business activity and those that constrain it."[63] In 2004, five types of business activities were evaluated in 133 countries: (1) starting a business; (2) hiring and firing workers (the "Employing Workers' Index," which became particularly controversial); (3) enforcing a contract; (4) getting credit; and (5) closing a business.[64] In 2005, two more measures were added for (6) registering property; and (7) protecting investors.[65] In 2007, additional measures evaluating (8) business taxes; (9) trading across borders; and (10) dealing with licenses were added.[66] From these submeasures the World Bank produces an ordinal ranking of countries on the ease of doing business, a ranking that suggests in 2010 the rather counterintuitive view that it is better to do business in Thailand, Georgia, Saudi Arabia, Malaysia, or Estonia versus Germany, the Netherlands, Austria, France, or Spain.[67]

Initial exposition by the World Bank of the premises of the project show the close intellectual affinity to LLSV's work, as the Bank concluded in 2004 that "[h]eavier regulation of business activities generally brings bad outcomes, while clearly defined and well-protected property rights enhance prosperity."[68] Lest one misses the point, the Bank also emphasized that "[c]ommon law countries regulate the least. Countries in the French civil law tradition the most."[69]

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61. *Id.*

62. *See generally* Kevin E. Davis & Michael B. Kruse, *Taking the Measure of Law: The Case of the Doing Business Project*, 32 LAW & SOC. INQUIRY 1095 (2007).

63. *Id.* at 1096 (internal quotation marks omitted).

64. *Id.* at 1097.

65. *Id.* at 1098.

66. *Id.*

67. World Bank Report, *Doing Business 2010, available at* http://www.doingbusiness.org/economyrankings/ (last visited Jan. 11, 2009).

68. Davis & Kruse, *supra* note 62, at 1102 (internal quotation marks omitted).

69. *Id.* (internal quotation marks omitted).

In a thoughtful evaluation of the Doing Business Initiative, Davis and Kruse praise the project for its attempt to systematically evaluate business environments. However, they also express concerns over the methodology, given that "law is inherently difficult to measure in quantitative terms,"[70] and given the lack of empirical evidence (other than from LLSV and acolytes we would suggest) that the parameters they have chosen to evaluate have a clear relationship with important social and economic outcomes in developing economies.[71] Moreover, some of the elements being evaluated are ideologically charged, such as those giving higher scores to countries in which it is easy to hire and fire workers and in which business taxes are low.[72] Seeing how the World Bank describes changes its methodology in 2009 for "scoring" labor gives a good indication of the perspective:

> The methodology for one of the Doing Business topics—employing workers—was updated this year. . . . The scope of the question on night and weekly holiday work has been limited to manufacturing activities in which continuous operation is economically necessary. Legally mandated wage premiums for night and weekly holiday work up to a threshold are no longer considered a restriction. In addition, the calculation of the minimum wage ratio was modified to ensure that an economy would not benefit in the scoring from lowering the minimum wage to below $1.25 a day, adjusted for purchasing power parity. This level is consistent with recent adjustments to the absolute poverty line. Finally, the calculation of the redundancy cost was adjusted so that having severance payments or unemployment protections below a certain threshold does not mean a better score for an economy.[73]

Clearly there are political forces at work much beyond LLSV's analysis to make these kinds of assumptions palatable to some people (but by no means not all people) working in an institution like the World Bank, whose primary goal is to eradicate poverty. It is surprising that a development agency's metric would reward pay levels below the absolute poverty line or would reward lowering social protections for workers who are fired or unemployed. Prior to

70. *Id.* at 1104.

71. *Id.* at 1109–12.

72. *Id.* at 1112–14.

73. THE WORLD BANK, IFC, & PALGRAVE MACMILLAN, DOING BUSINESS 2010: REFORMING THROUGH DIFFICULT TIMES 78 (2009).

the changes in methodology in 2009, that was precisely the direction that countries' reform efforts could take in order to increase their score in the Doing Business Initiative, and to increase their likelihood of attracting funding from the World Bank or the U.S. Millenium Challenge Accounts.[74] Further research should evaluate the extent to which other, more direct World Bank development initiatives with proven potential to reduce poverty, such as educating girls in rural societies, were sacrificed on behalf of the Doing Business Initiative.

To the extent that LLSV's work informs both the methodology and assumptions of the Doing Business project—and their own retrospective discusses their involvement and the reforms the project has encouraged—concerns regarding the reliability of LLSV's methodology and results (as discussed above and by Deakin and other scholars)[75] are heightened. Some of the legal reforms that the Doing Business Initiative promotes presumably have positive consequences for enhancing social welfare outcomes, such as reforms that shrink the size of the unofficial economy or permit extremely low-income people to advance ownership claims over property. By failing to untangle those reforms that improve the lives of the poor from those that simply mesh with the political commitments of economists such as LLSV, though, the World Bank risks undermining both its reputation and its efficacy in achieving its core mission.

B. LLSV and the Promotion of Shareholder Corporate Governance

It is beyond the remit of this short Essay to demonstrate the various ways in which European countries and companies have been under constant pressure over the last three decades to adopt so-called Anglo-Saxon concepts of corporate governance and finance; that is, until August 2007 when the global financial fabric began to unravel. When the intellectual history of this era is written, these authors have no doubt that it will show that a "west wind was blowing" as cadres of professors, asset managers, shareholder activists, and institutional investors from the United States enjoyed European hospitality on a quite regular basis (every summer for many professors), even as they encouraged European leaders,

74. *See* Davis & Kruse, *supra* note 62, at 1116.

75. Armour et al., *supra* note 54.

countries, and companies to adopt American values, specifically American "shareholder value," rather than stakeholder value, as the touchstone of proper corporate governance. At a macro level, a deeply held belief in the superiority of market mechanisms rather than government involvement for solving important social coordination problems underlies much of this promotional activity, influenced by three decades of deregulatory political and economic theory.[76]

LLSV's thesis shares this faith in markets, and their work supports legal rules, such as those protecting minority shareholders, to encourage financial markets to flourish. As they summarize:

> In sum, there is by now a great deal of evidence that legal origins influence legal rules and regulations, which in turn have substantial impact on important economic outcomes—from financial development, to unemployment, to investment and entry, to the size of the unofficial economy, to international trade. Much of this evidence suggests that common law is associated with better economic outcomes than French civil law.[77]

Even so, they point out that "it is less clear that legal origins predict aggregate growth."[78] The authors expound:

> [The finding that it is uncertain whether legal origins predict aggregate growth] resonates with the obvious observation made by LLSV (1998) that countries like France and Belgium achieved high living standards despite their legal origin. One possible explanation of the aggregate growth evidence is that civil law countries have found compensating mechanisms to overcome the baggage of their legal tradition in the long run.[79]

Indeed, as the authors stated in a footnote, "We note, however, that the evidence on the relationship between [legal origin] institutions and aggregate growth more generally, which seemed substantial a few years ago, has been crumbling."[80]

This last admission is the point at which one wonders if the asserted superiority of the common law system for "better economic

76. Frank Jan De Graaf & Cynthia A. Williams, *The Intellectual Foundations of the Global Financial Crisis*, 32:2 U. NEW S. WALES L. REV. 390, 402–05 (2009).

77. La Porta et al., *supra* note 4, at 302.

78. *Id.*

79. *Id.*

80. *Id.* at 302 n.11 (citation omitted).

outcomes" is also crumbling. If the financial development that is encouraged by common law legal origins is not leading to higher aggregate economic growth, then on what basis is financial development a useful measure of better economic outcomes? And on what basis is a high level of financial development *per se* a good thing and demonstrative of institutional superiority if it *does not* lead to higher aggregate growth in the real economy? These are questions policy makers are posing today in light of the global financial crisis. An example is found in the Turner Review for the Financial Services Authority (FSA) in the U.K., where Lord Turner observed that in the U.K. and the U.S., from the 1980s on, "[t]he evolution of the securitised credit model was accompanied by a remarkable growth in the relative size of wholesale financial services within the overall economy, with activities internal to the banking system growing far more rapidly than end services to the real economy."[81]

It seems likely that the measure of financial development LLSV use as their indicator of better outcomes from common law legal origins, stock market capitalization per GDP,[82] is simply a measure of the degree of financialization of a particular economy. This view is consistent with the data LLSV present at Table 7 of their ten-year retrospective reprinted in part below. This table shows that most countries experienced an increase in stock market capitalization per GDP between 1990 and 1999,[83] a time when the technology bubble in stock prices was developing in many advanced economies, pushing stock market values higher generally. Table 7 also shows that in a number of countries, the ratio of stock market capitalization to GDP grew dramatically higher from 1990 to 1999, most notably in the United Kingdom (from 0.81 to 2.25) (English legal origin); the United States (0.54 to 1.52) (English legal origin); the Netherlands (0.50 to 2.03) (French legal origin); Switzerland (1.93 to 3.23) (German legal origin); and Sweden (0.39 to 1.77) (Scandinavian legal origin).[84]

81. FINANCIAL SERVICES AUTHORITY, THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 16 (2009).

82. La Porta et al., *supra* note 4, at 316–18.

83. *Id.* at 317.

84. *Id.*

TABLE 7

STOCK MARKET CAPITALIZATION OVER GDP[85]

Country	Legal Origin	1990	1999
Australia	English	0.37	1.13
Canada	English	1.22	1.22
India	English	0.16	0.46
South Africa	English	1.33	1.20
United Kingdom	English	0.81	2.25
United States	English	0.54	1.52
Avg Common Law		0.74	1.30
Argentina	French		0.15
Belgium	French	0.31	0.82
Brazil	French	0.08	0.45
Chile	French	0.50	1.05
Cuba	French		
Egypt, Arab Rep.	French	0.06	0.29
France	French	0.24	1.17
Italy	French	0.13	0.68
Netherlands	French	0.50	2.03
Russian Federation	French		0.11
Spain	French	0.41	0.69
Avg French Law		0.28	0.74
Austria	German	0.17	0.17
Germany	German	0.20	0.67
Japan	German	1.64	0.95
Switzerland	German	1.93	3.23
Avg German Law		0.99	1.26
Denmark	Scandinavian	0.67	0.67
Norway	Scandinavian	0.23	0.70
Sweden	Scandinavian	0.39	1.77
Avg Scandinavian Law		0.43	1.05

If, as it seems, the legal origins measure of stock market capitalization to GDP does not relate to or predict aggregate growth but perhaps does measure financialization, then this outcome measure may, *in more market economies*, be inversely related to better economic outcomes. While this is frank speculation, it is based on the view that the underlying strengths and stabilities of European social democracies perhaps ameliorated the worst excesses and instabilities of financialization even where financialization was well

85. *Id.* at 317 tbl.7 (data from previous years omitted).

advanced (such as in the Netherlands, Switzerland, and Sweden, above).

With our argument that financialization *per se* is not a useful measure of "better economic outcomes," and with debate amongst economists concerning the value to countries' economies of foreign direct investment in predicting better economic outcomes for developing economies,[86] LLSV need to concentrate on higher unemployment levels and a larger informal economy in civil law countries to make the case that "common law is associated with better economic outcomes."[87] Unemployment levels and the extent of informal economies are undoubtedly important measures of real economic benefits or detriments from systems of laws, regulations, and norms, and so it is here that LLSV's analysis is most persuasive. Yet, LLSV seem to be engaging in academic cherry picking. A more comprehensive look at other measures of the economic benefits of the European (civil law) systems of social and economic organization suggests as much.

In his recent book, *Common Wealth: Economics for a Crowded Planet*, economist Jeffrey Sachs compares data on various measures of economic health between the social-welfare states of Denmark, Finland, Norway, and Sweden; the mixed economies of Austria, Belgium, France, Germany, Italy and the Netherlands (which has aspects of both social welfare and mixed economy); and the more free-market countries of Australia, Canada, Ireland, New Zealand, the United Kingdom, and the United States.[88] Professor Sachs presents data showing lower poverty rates in the social-welfare states (5.6%) compared to the mixed economies (9%), compared to the free-market states (12.6%), with the United States showing a poverty rate of 17.1%.[89] (The poverty rate is defined as the percentage of people living at less than half the average national household income).[90] The Gini coefficient, which measures the equality of

86. *See, e.g.,* Joseph E. Stiglitz, *Capital-Market Liberalization, Globalization, and the IMF*, 20 OXFORD REV. ECON. POL'Y 57, 64–65 (2004). LLSV use higher levels of foreign direct investment as a positive measure of a country's economic health, but as the Stiglitz article shows, this view is not universal among economists: foreign direct portfolio investment is associated with higher levels of economic and currency volatility and political instability.

87. La Porta et al., *supra* note 4, at 302.

88. JEFFREY D. SACHS, COMMON WEALTH: ECONOMICS FOR A CROWDED PLANET 258 (2008).

89. *Id.* at 261.

90. *Id.*

wealth distribution within countries, where 0 is perfectly equal and 100 is perfectly unequal was 24.7 for social-welfare states; 28 for the mixed economies; and 32 for the free-market economies, with the United States at 35.7.[91] Average per capita income is higher in the social-welfare states as compared to the free-market economies, with the mixed economies placing third.[92] And, contrary to LLSV's conclusions, Professor Sachs presents data showing that "the social-welfare states have an even higher employment rate (number of workers as a share of the working-age population) than the free-market countries."[93] He concludes that "the social-welfare states have achieved high levels of incomes, low rates of poverty, and a more equal distribution of incomes than the free-market societies."[94] These conclusions provide a sharp contrast to LLSV's incomplete picture of the economic outcomes asserted to flow from legal origins, and suggest that the debates over the superiority of different capitalist systems of economic organization should not be considered over.

IV. CONCLUSION

LLSV's research purporting to demonstrate the importance of the legal origins of a country for its stock market development and ownership dispersion, mediated through the protection of minority shareholders as against directors, has been subjected to enough further, careful analysis that we can see both the inaccuracies and the importance of their research.

In this Essay, we have suggested that economic sociology has much to add to the raw facts of ownership patterns within countries. There are provocative hints that companies with controlling shareholders can actually outperform companies without, contingent on the nature of the owners (family, state, bank, parent company, etc.), the type of industrial sector, the stage of the firm's life cycle, and the other institutional arrangements in the country. Putting ownership patterns on the agenda of academic inquiry was clearly an important contribution by LLSV. Understanding what those patterns imply about firm performance, within different institutional

91. *Id.*
92. *Id.* at 262.
93. *Id.* at 261.
94. *Id.* at 262.

arrangements and complementarities, is yet to be fully addressed, either in their work or in comparative corporate governance generally.

We have also suggested that it is important to understand the contributions, if any, of legal origins to positive *economic* measures of a country's health, fully conceived. Financial measures alone do not suffice to provide that understanding, as we have argued above. In light of the collapse of innovative financialization over the past year, and the resulting global recession, we should re-examine LLSV's fundamental conceptions—and perhaps misconceptions—of the value of stock market capitalization *per se* as a measure of healthy economics.

In short, we have not reached the "end of history" for law and finance.

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