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# Unpacking Adaptability

*Andreas Engert\** and *D. Gordon Smith\*\**

## I. INTRODUCTION

Legal Origins Theory holds that “legal origins—broadly interpreted as highly persistent systems of social control of economic life—have significant consequences for the legal and regulatory framework of the society, as well as for economic outcomes.”<sup>1</sup> First proposed over a decade ago in a pair of papers by Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny (“LLSV”),<sup>2</sup> Legal Origins Theory quickly grabbed the attention of legal scholars, but the caricatured portrayal of common law and civil law systems in those early papers<sup>3</sup> prompted scathing criticisms.<sup>4</sup> Chastened but unbowed, LLSV and other economists continued to refine the theory.<sup>5</sup> In a recent review of the substantial literature

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1. Rafael La Porta et al., *The Economic Consequences of Legal Origins*, 46 J. ECON. LITERATURE 285, 326 (2008) [hereinafter La Porta, *Economic Consequences*].

2. Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) [hereinafter La Porta, *Legal Determinants*]; Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998) [hereinafter La Porta, *Law and Finance*].

3. See Nicholas Thompson, *Common Denominator*, LEGAL AFF., Jan.–Feb. 2005, at 46 (“Asked how much the group knew about common law and civil law when the project commenced, Shleifer said, ‘Nothing, literally.’”).

4. In this essay, we focus on corporate law, where the criticisms of Legal Origins Theory have been the strongest. See, e.g., Sofie Cools, *The Real Difference in Corporate Law Between the United States and Continental Europe: Distribution of Powers*, 30 DEL. J. CORP. L. 697, 734 (2005) (“[T]he difference between common law and civil law with regard to shareholder protection is not as straightforward as the numbers in *Law and Finance* suggest—at least not with regard to the corporate law of these traditions.”); Holger Spamann, *On the Insignificance and/or Endogeneity of La Porta et al.’s ‘Antidirector Rights Index’ Under Consistent Coding*, at 1 (ECGI Law Working Paper No. 67/2006, 2006) (“Proper re-coding reveals . . . that the results in La Porta et al. 1997, 1998 came about only through strong and systematic measurement error (inconsistent coding).”).

5. The original measure of shareholder protection—which LLSV called the anti-director index—has been replaced by two other measures of shareholder protection. See Simeon Djankov et al., *The Law and Economics of Self-Dealing*, 88 J. FIN. ECON. 430, 461 (2008) [hereinafter Djankov, *The Law and Economics of Self-Dealing*]; Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1 (2006) [hereinafter La Porta, *What Works in*

generated by Legal Origins Theory, three of the LLSV authors concluded, “Since their publication about a decade ago, the two LLSV articles have taken some bumps. . . . [B]umps notwithstanding, the basic contribution appears to us to still be standing, perhaps even taller than a decade ago.”<sup>6</sup>

Despite this sanguine assessment of Legal Origins Theory, LLSV have not persuasively described the mechanisms through which legal origins facilitate economic development. The question asked by Paul Mahoney still bedevils Legal Origins Theory: “Why should legal origin affect economic growth?”<sup>7</sup> In this paper, we explore one proposed mechanism: *adaptability*. The adaptability hypothesis suggests that “legal traditions differ in their ability to evolve with changing conditions . . . and legal traditions that adapt efficiently to minimize the gap between the contracting needs of the economy and the legal system’s capabilities will foster financial development more effectively than more rigid systems.”<sup>8</sup>

Economic development requires behavioral innovations, which stretch the fabric of law. Thus, adaptability is said to be an essential characteristic of a legal system that would facilitate economic development. As we discuss in some detail below, the chief methodological challenge confronting the empirical study of adaptability is that researchers cannot measure adaptability directly. Legal Origins Theory attempts to surmount this challenge, in the first instance, by using legal institutions as proxies for adaptability.<sup>9</sup> One of the foundational assumptions of Legal Origins Theory is that courts engage in highly contextualized rulemaking that improves the quality of law over time.<sup>10</sup> Legal Origins Theory then takes this

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*Securities Laws?*].

6. La Porta, *Economic Consequences*, *supra* note 1, at 326.

7. Paul G. Mahoney, *The Common Law and Economic Growth: Hayek Might Be Right*, 30 J. LEGAL STUD. 503, 506 (2001). Mahoney’s answer, though difficult to test empirically, has been embraced by LLSV. Inspired in part by the work of Friedrich Hayek (including FRIEDRICH A. HAYEK, *THE CONSTITUTION OF LIBERTY* (1960), and FRIEDRICH A. HAYEK, *LAW, LEGISLATION AND LIBERTY: A NEW STATEMENT OF THE LIBERAL PRINCIPLES OF JUSTICE AND POLITICAL ECONOMY* (1973)), Mahoney argued that “the common law is historically connected to strong protection for property rights against state action, whereas the civil law is connected to a strong and less constrained central government.” Mahoney, *supra* at 507.

8. Thorsten Beck et al., *Law and Finance: Why Does Legal Origin Matter?*, 31 J. COMP. ECON. 653, 655 (2003) (citation omitted).

9. See La Porta, *Economic Consequences*, *supra* note 1, at 302–10.

10. *Id.* at 305.

assumption one step further, asserting that “judicial law making and adaptation play a greater role in common than in civil law.”<sup>11</sup> Thus, legal origin becomes a second-order proxy for adaptability. We contend that adaptability is undertheorized and that a more nuanced understanding of adaptability reveals the implausibility of legal origin as proxy for adaptability.

## II. THE PURPORTED LINK BETWEEN ADAPTABILITY AND ECONOMIC SUCCESS

Legal Origins Theory begins with the following proposition: “The two central dangers that any society faces are disorder and dictatorship.”<sup>12</sup> Four institutions—private ordering, private litigation, regulation, and state ownership, ranked in order of increasing state power<sup>13</sup>—control these two dangers. A “fundamental tradeoff” inheres in the choice of institutions: “[A] state that has more powers to control disorder also has more for dictatorial

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11. *Id.* at 306.

12. Simeon Djankov et al., *The New Comparative Economics*, 31 J. COMP. ECON. 595, 598 (2003).

Disorder refers to the risk to individuals and their property of private expropriation in such forms as banditry, murder, theft, violation of agreements, torts, or monopoly pricing. Disorder is also reflected in the private subversion of public institutions, such as courts, through bribes and threats, which allows private violators to escape penalties. Dictatorship refers to the risk to individuals and their property of expropriation by the state and its agents in such forms as murder, taxation, or violation of property. Dictatorship is also reflected in expropriation through, rather than just by, the state, such as occurs when state regulators help firms to restrict competitive entry. Some phenomena, such as corruption, reflect both disorder and dictatorship. When individuals pay bribes to avoid penalties for harmful conduct, corruption is a reflection of disorder. When officials create harmful rules to collect bribes from individuals seeking to circumvent them, corruption is a cost of dictatorship.

*Id.*

13. *Id.* at 601.

These four basic strategies differ in the degree of public control. No public involvement is required with competition and private orderings. Courts employ impartial judges enforcing the rules of good behavior. These rules do not even need to come from legislation; rather, they may derive from custom or from judge-made common law. Even in this case, the judge is a public agent with decision-making authority. With regulators, the state writes the rules, inspects the product before it is sold, and penalizes sellers for delivering a bad product. Both the scope of government activity and its centralization are increased relative to independent courts. Finally, with state ownership, the government takes complete control over an activity.

*Id.*

abuse.”<sup>14</sup> The efficient institutional arrangement for a particular society is the one that minimizes the social costs of controlling disorder and dictatorship.

Historically, legal systems either evolved to satisfy these competing demands<sup>15</sup> or were imposed via transplantation.<sup>16</sup> In either event, Legal Origins Theory holds that the resulting legal systems became important determinants of future economic development. As noted above, adaptability has come to play a crucial role in this story. According to Legal Origins Theory, adaptable legal systems produce superior substantive law that, in turn, leads to superior economic outcomes. While causation in Legal Origins Theory runs from adaptability to substantive law to economic outcomes,<sup>17</sup> as we will see later, empirical support for the adaptability hypothesis seems to begin with an examination of substantive law and to flow backwards to an inference of adaptability.<sup>18</sup>

In *Law and Finance*, the seminal paper in Legal Origins Theory,<sup>19</sup> LLSV began with an idea about the possible role of law in economic development, and they set out to test that idea by

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14. *Id.* at 598–99.

15. *Id.* at 605 (“In the 12th and 13th centuries, France was relatively decentralized and disorderly, with local notables successfully able to subvert all local institutions to their own advantage. In contrast, England was relatively peaceful and the king maintained control over the entire country. To counter disorder, it was efficient for France to adopt a legal system with more dictatorship than England’s, even at the cost of greater scope for sovereign abuse of the law.”).

16. *Id.* at 609 (“Although some institutional diversity can be explained by focusing on efficient choices, transplantation is a dramatic deviation from this approach. As European powers conquered much of the world in the 19th century, they brought with them their institutions, including their laws. A significant portion of the institutional variation among countries, especially with regard to legal systems, can be accounted for by transplantation.”).

17. Ironically, Legal Origins Theory is not much interested in the origins of law. One could imagine telling a story in which a set of legal rules constituted a starting point from which adaptation occurred. Under such a story, if path dependence played a prominent role, the content of those initial rules would become an important predictor of later developments. But Legal Origins Theory is not concerned with any substantive starting point. Instead, Legal Origins Theory focuses on the substantive *results* of legal evolution. Under this story, the importance of “legal origins” is procedural—the ability to adapt—not substantive.

18. While we suspect that LLSV would not phrase the point quite as we have done here, their recent survey article concedes that research on adaptability is largely theoretical, and that the limited number of attempts at empirical research on adaptability have produced mixed results. See La Porta, *Economic Consequences*, *supra* note 1, at 305.

19. *Law and Finance* was published in 1998, and *Legal Determinants of External Finance* was published in 1997, but LLSV refer to the former as “our earlier article.” La Porta, *Legal Determinants*, *supra* note 2, at 1131.

examining the content of selected legal rules in forty-nine countries. More specifically, LLSV theorized that some countries provide greater legal protections to external investors than other countries, and LLSV conjectured that the strength of these legal protections would be correlated with levels of external investment. LLSV collected data on legal rules relating to shareholder and creditor protection, hoping to find that “differences in legal protections of investors might help explain why firms are financed and owned so differently in different countries.”<sup>20</sup>

In that first paper, they purported to find substantial differences among countries with respect to the content of legal rules, and they also noticed a pattern in their data that would come to define their project. Differences in legal rules seemed to track two broadly defined legal traditions: common law and civil law. LLSV also observed differences among the three major families in the civil law tradition: French, German, and Scandinavian.<sup>21</sup> The implication of these observations was that LLSV could “compare both the individual legal rules and whole legal families across a large number of countries.”<sup>22</sup> More provocatively, their data on legal rules could be combined with data on economic outcomes (e.g., per capita gross national product) to permit judgments about the relative quality of legal systems.<sup>23</sup>

The first paper did not make much progress on the correlation of legal protections with levels of external investment, but in the companion piece, *Legal Determinants of External Finance*, LLSV presented data on financial markets and concluded that “the legal environment has large effects on the size and breadth of capital markets across countries.”<sup>24</sup> The findings in these first two papers were criticized on various grounds,<sup>25</sup> but in a recent review essay, LLSV claim, “We have corrected our mistakes and have moved on to conceptually less ambiguous measures [that] have strengthened the original results.”<sup>26</sup>

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20. La Porta, *Law and Finance*, *supra* note 2, at 1114.

21. *Id.*

22. *Id.* at 1115.

23. *Id.* at 1133, 1142–43.

24. La Porta, *Legal Determinants*, *supra* note 2, at 1132.

25. For a useful summary of criticisms, see Mathias Siems & Simon Deakin, *Comparative Law and Finance: Past, Present and Future Research*, J. INSTITUTIONAL & THEORETICAL ECON. (2010).

26. La Porta, *Economic Consequences*, *supra* note 1, at 291–92. The source of their pride

In the first stages of the development of Legal Origins Theory, LLSV did not discuss the adaptability hypothesis. Nevertheless, one perceives some recognition of the need to explain *why* the common law should provide better investor protections than the civil law. In *Legal Determinants of External Finance*, for example, LLSV offered this rather stark distinction between the two systems: “English law is common law, made by judges and subsequently incorporated into [legislation]. French, German, and Scandinavian laws, in contrast, are part of the scholar and legislator-made civil law tradition, which dates back to Roman law.”<sup>27</sup> Over the ensuing years, LLSV have developed a more nuanced understanding of legal systems, but they continue to rely on the assumption that common law systems depend more heavily on judge-made law than civil law systems, even though legal scholars have pointed to the heavy reliance of common law systems on statutes and regulations for the protection of investors.<sup>28</sup> Regardless of how this debate is resolved, the important point for present purposes is that LLSV associate common law systems with courts, and they associate courts with adaptability: “the greater respect for jurisprudence as a source of law in the common law countries, especially as compared to the French civil law countries, suggests that common law will be more adaptable to the changing circumstances.”<sup>29</sup>

The manner in which Legal Origins Theory has developed shows that adaptability was an afterthought for LLSV. This is not to say that adaptability is unimportant,<sup>30</sup> but rather that it has not been

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was a pair of articles measuring shareholder protection through self-dealing regulation and securities laws, respectively. Djankov, *The Law and Economics of Self-Dealing*, *supra* note 5; La Porta, *What Works in Securities Laws?*, *supra* note 5.

27. La Porta, *Legal Determinants*, *supra* note 2, at 1131 (citation omitted). Note the awkwardly phrased assumption that the common law is “subsequently incorporated into legislature.” As discussed below, this assumption becomes a cornerstone of LLSV’s response to legal scholars who claim that much of investor-protection law is codified.

28. See Mark J. Roe, *Legal Origins, Politics, and Modern Stock Markets*, 120 HARV. L. REV. 460 (2006); Priya P. Lele & Mathias M. Siems, *Diversity of Shareholder Protection in Common Law Countries*, 5 J. INSTITUTIONAL COMPARISONS 3 (2007); Howell Jackson & Mark J. Roe, *Public and Private Enforcement of Securities Laws: Resource-Based Evidence* (Harv. Pub. Law Working Paper No. 08-28, 2009).

29. La Porta, *Economic Consequences*, *supra* note 1, at 305.

30. Indeed, absent an explanation for the superiority of the common law, one might surmise that the correlation of legal systems with economic outcomes was simply correlation without causation. For alternative hypotheses that have been suggested to explain the correlation, see *id.* at 310–16.

subjected to the same detailed attention as other aspects of the project. Our reading of LLSV goes like this: countries with superior economic outcomes tend to have superior substantive law (i.e., common law), which, *by its very existence*, implies superior adaptability. In this research, economic outcomes and substantive law are observed empirically, but adaptability is merely implied. Thus, adaptability is not so much an explanatory variable or causal mechanism as a designation that adheres to successful legal systems. In the language of logicians, it is not a premise, but a conclusion. If a country is economically successful, the legal system must be adaptable.

The foregoing would be viewed as an exaggeration by LLSV, who do not rely solely on logic for the proposition that common law systems are more adaptable than civil law systems.<sup>31</sup> Yet as matters stand, LLSV's notion of adaptability is severely undertheorized. In what follows, we look more deeply into both the theoretical foundations and the empirical support for the adaptability hypothesis.

### III. UNPACKING THE THEORY

Intuitively, the idea that adaptability of the law conduces to better rules and from there to economic success is appealing. Nevertheless, it is far from clear what "adaptability" in this account actually *means*. Without a more precise understanding of the concept, there is no way of comparing the degree of adaptability among different jurisdictions. In the context of Legal Origins Theory, we need to distinguish adaptability from other stories about why common law jurisdictions supposedly differ from other legal families, such as political explanations. Also, if adaptability is to provide a causal link from legal origin to substantive merit, adaptability must itself be distinct and separable from economic outcomes. In this section, we clarify some of these conceptual issues and define adaptability. As it turns out, adaptability is a rather complex quality, which does not bode well for any test of a hypothesis that presupposes the ability to compare adaptability across jurisdictions.

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31. As a matter of theory, they rely on FRIEDRICH A. HAYEK, *THE CONSTITUTION OF LIBERTY* (1960). See La Porta, *Economic Consequences*, *supra* note 1, at 305. For the role of the courts as a proxy for greater adaptability of the common law, see *infra* Part IV.B.

*A. Defining Adaptability*

As a first shot, an adaptable legal system should be one that responds efficiently to changes in regulated behavior when existing legal rules are not up to the task. We therefore begin by contemplating changes in regulated behavior, which we call *behavioral innovations*. A behavioral innovation is any deviation from a familiar pattern of behavior. The term “innovation” is not meant to suggest that the new behavior is desirable from a social perspective. A behavioral innovation can create value, but it may just as well produce large costs for society. For example, value-enhancing innovations in business and finance might include milestone financing in venture capital contracts, stock option compensation for management, and the index fund. By contrast, some innovations serve the interests of the innovators but impose social costs exceeding the benefits. “Bad” innovations may be new ways of exploiting an agency relationship, such as shifting assets from the balance sheet to misrepresent earnings, inventing novel methods for asset tunneling, or filing frivolous lawsuits to extort unjustified ransom payments. The category of value-destroying innovations emphasizes the law’s role in curbing agency costs. Adaptability implies that the law responds quickly and effectively to new agency problems and does not allow them to hamper economic activity for an extended period of time. In this regard, adaptability takes up investor protection as a main theme of Legal Origins Theory.

Most innovations cannot be easily categorized as either value-enhancing (“good”) or value-destroying (“bad”), but an optimal legal system would be adept at sorting innovations so as to permit and even encourage value creation while suppressing harmful innovations. Thus, adaptability must be more than random responses to behavioral innovations. On the other hand, one cannot simply infer adaptability from superior economic outcomes or from superior legal rules. In doing so, the concept of adaptability would cease to be an explanation, other than a tautological one. To account for the substantive quality of legal rules, therefore, adaptability must be something distinct and separable from economic or legal outcomes.

What makes adaptability more than a truism is the responsiveness of the legal system. A legal system may choose not to react to a behavioral innovation because rule-makers adhere to excessively “formalist” views, because they consider the costs associated with a change to outweigh the benefits of the change, or because they are

lazy. Whatever the reasons, responsiveness refers to the possibility that a behavioral innovation would not cause a change in law, even though a new legal rule might be superior in some respects to the existing legal rule. The adaptability of a given legal system, therefore, depends on both (i) the responsiveness to behavioral innovations (i.e., readiness to change the law in reaction to a change in regulated behavior) and (ii) the proficiency in devising efficient legal rules (i.e., the probability that the response is in fact value-enhancing).

Under this account of adaptability, legal rules may be less than optimal either because the legal system failed to respond to a behavioral innovation or because the responses, past or present, produce rules that are substantively deficient. The fact that legal systems differ in their responsiveness to change is not a new observation. For instance, many commentators claim that civil law courts are more “formalist” than common law courts in applying legal authority and, therefore, less responsive to behavioral innovations. But even when the courts (or legislatures or regulatory agencies) are ready to respond to behavioral innovations, the new legal rules that they create will not necessarily be value-enhancing. Responsiveness, standing alone, is insufficient to produce the desired results. Law-making institutions also have to produce good legal rules with some consistency.

### *B. The Optimal Amount of Adaptability*

The capability of legal institutions to devise value-enhancing rules is undeniably important, but the responsiveness of legal institutions to behavioral innovations can be a two-edged sword. When a law-making institution changes a legal rule, the institution engages in a new policy analysis *instead of* subjecting the behavior to existing legal rules. Thus, responsiveness implies rejection of legal authority.

It follows that the more responsive a legal system, the less people can rely on legal authority to predict how the law is going to deal with their behavior. As individual cases are never exactly alike, a law-making institution can almost always find some amount of behavioral innovation to distinguish present circumstances from the past. At extreme levels of responsiveness, the existing body of legal authority would cease to provide meaningful guidance for behavior. We perceive, therefore, a tradeoff between the benefits of responsiveness

and the law's role in guiding behavior.<sup>32</sup> Thus, a legal system may not only suffer from too little responsiveness (and adaptability), but also from excessive responsiveness (and a lack of predictability).<sup>33</sup> The optimum amount of responsiveness depends on how important predictability is for a given type of behavior. It also varies with the degree of proficiency of the law-making institution because responsiveness is more valuable if it is more likely to result in an efficient rule.

The tradeoff between responsiveness (adaptability) and predictability is still consistent with Legal Origins Theory's story that the common law is more efficient because it is more adaptable. It may be that civil law jurisdictions are below the optimal level of adaptability, and that being more adaptable would be more efficient. However, the opposite can just as well be true: the more adaptable jurisdiction may have moved beyond the optimum where greater adaptability, on balance, hurts business activity more than it fosters desirable innovation. If we assume that common law jurisdictions are more adaptable, this could be a driver of economic success, but also an impediment to it. In any event, increasing the adaptability of the law—and hence making the law less predictable—is not a general policy advice to enhance overall efficiency.

#### IV. UNPACKING THE EVIDENCE (WHAT LITTLE THERE IS)

In theory, adaptability can explain why a particular jurisdiction has superior legal rules, though the argument is more complicated than the original conjecture. The even greater challenge lies in putting the theory to a test.

##### *A. The Daunting Difficulty of Observing Adaptability*

To detect a link between adaptability and legal rules one must be able to measure the degree of adaptability in a given jurisdiction.

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32. See Mathias M. Siems, *Legal Adaptability in Elbonia*, 2 INT'L J.L. CONTEXT 393, 404–05 (2006) (arguing that adaptability tends to collide with legal certainty).

33. The debate on charter competition provides an example in point: Delaware has been accused of keeping its law excessively indeterminate. See Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998) (arguing that indeterminacy increases Delaware's market power); Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1232 (2001) (explaining indeterminacy as a means of price discrimination in the market for corporate charters).

This is not a trivial exercise. As noted above, Legal Origins Theory seems to suggest that the best evidence of adaptability is the sort of robust economic development associated with countries that have the preferred legal system (i.e., common law). Of course, this is not a viable strategy for testing the adaptability hypothesis because it assumes the very link that it seeks to detect. In fact, we cannot think of any promising way to capture the proficiency aspect of adaptability, other than looking at the results of the rulemaking process.<sup>34</sup> Measuring adaptability, therefore, focuses on measuring the law's responsiveness to behavioral innovations.<sup>35</sup>

Unfortunately, responsiveness is an evasive feature as well. A plausible approach would be to look at the amount of rule change in a jurisdiction. But what exactly constitutes a rule change? One might imagine a quantitative measure of new rules created by the legislature or regulatory agencies.<sup>36</sup> Because statutes and regulations are formally enacted and promulgated, there is a clear-cut event that marks the change in applicable rules. But even if one arrived at a method for counting such rule changes, it would only reflect the responsiveness of legislatures and regulators. As we will see, LLSV's claim that common law jurisdictions are more adaptable than their civil law counterparts rests critically on the role of the courts. Leaving out rule changes brought about by the courts would miss an

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34. One potential avenue would be to measure the resources devoted to rulemaking. However, at least with regard to the courts, it is difficult to separate rulemaking from simple adjudication. The sheer volume of litigation does not appear to be a good proxy for the courts' ability to create efficient rules.

35. In a recent study of legal evolution, John Armour, Simon Deakin, Priya Lele, and Mathias Siems describe two types of study that can contribute to our understanding of the links between law and financial development. The study of "outcomes" would ask whether changes in particular legal rules lead to changes in financial markets (or vice versa), while the study of "mechanisms" would examine changes in the various protections afforded to shareholders, creditors, or workers. John Armour et al., *How Do Legal Rules Evolve? Evidence from a Cross-Country Comparison of Shareholder, Creditor, and Worker Protection*, 57 AM. J. COMP. L. 579, 579–80 (2009). Outcome studies could attempt to test the adaptability hypothesis by measuring either proficiency (when the studies ask whether changes in particular legal rules lead to changes in financial markets) or responsiveness (when the studies ask whether changes in financial markets lead to changes in particular legal rules). Armour et al. use the study of mechanisms to propose an alternative to the adaptability and political channels, which they call the "institutional channel." *Id.* at 596.

36. For a study in this vein, see Katharina Pistor et al., *Innovation in Corporate Law*, 31 J. COMP. ECON. 676, 689–91 (2003) (counting major changes to corporate law statutes in ten jurisdictions).

important mechanism of adaptability—the most important one according to Legal Origins Theory.

At the same time, measuring the amount of new rules created by the courts is next to impossible. The key difficulty lies in distinguishing between applying an existing rule and creating a new one. When confronted with a behavioral innovation, a court can still invoke an existing rule—and will tend to do so—to decide the case. The observer is then left to determine if applying the rule to the fact pattern amounts to “changing” the rule, which would require a definition of the original rule’s scope as a reference point. It is hard to see how such an analysis might be conducted with a minimum degree of reliability.

Summing up, there is little hope of observing the amount of rule changes as a proxy for the law’s responsiveness and hence adaptability. In view of the methodological difficulties, it is hardly surprising that evidence for or against the adaptability hypothesis has remained scarce.<sup>37</sup> The only argument that LLSV have put forward on behalf of the adaptability hypothesis is a rather indirect piece of evidence—the role of the courts as a proxy for adaptability.

#### *B. The Uncertain Role of the Courts*

Legal Origins Theory claims that adaptability is an important comparative advantage of common law systems over civil law systems. The source of the common law’s comparative advantage is courts, and what LLSV admire about courts is that “the ability of judges to react to changing circumstances—the adaptability of common law—tends to improve the law’s quality over time.”<sup>38</sup> The only attempt at studying the court-adaptability nexus empirically has been undertaken by Thorsten Beck, Asli Demirgüç-Kunt, and Ross Levine, who contrasted two theories of why legal origin influences economic development—the “adaptability channel” and the “political channel”—and concluded that “legal origin matters because legal traditions differ in their ability to adjust efficiently to evolving socioeconomic conditions.”<sup>39</sup> Unfortunately for LLSV, the

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37. See Siems, *supra* note 32, at 399–403 (providing an extensive collection of proxies for adaptability).

38. La Porta, *Economic Consequences*, *supra* note 1, at 305.

39. See Beck et al., *supra* note 8, at 672.

limitations of this study are substantial. The authors identify only two “indicators” of adaptability for each country:

(1) “Case law” is a dummy variable borrowed from an LLSV paper,<sup>40</sup> which gives the case law variable a value of 1 if “judicial decisions in a given country are a source of law.”<sup>41</sup> Otherwise, the variable is assigned a value of 0.<sup>42</sup> To determine whether a country is in one category or the other, LLSV relied on the *International Encyclopedia of Comparative Law*, published in 1973.<sup>43</sup>

(2) The other indicator is “legal justification,” which “indicates whether judgments are based on statutory law rather than on principles of equity.”<sup>44</sup> This variable is also borrowed from an LLSV paper,<sup>45</sup> and it is assigned a value of 0, 0.33, 0.67, or 1, “where higher values signify the legal system imposes greater requirements that judgments be based on statutory law.”<sup>46</sup>

While we applaud the effort of the authors to bring some rigor to the analysis of adaptability, we find these variables much too simplistic. Even if the variables were coded with care, whether judicial opinions are a “source of law” is the sort of inquiry that does not lend itself to binary resolution. Moreover, we agree with Mathias Siems that the legal justification variable is “too limited[,] as the degree of legal adaptability of a particular country depends on a larger set of criteria.”<sup>47</sup>

The dearth of explicit empirical support is but one shortcoming of LLSV’s claim that the greater reliance on courts makes the common law more adaptable. Ironically, the supposedly superior substantive law identified in Legal Origins Theory does not consist primarily of judge-made rules. In *Law and Finance*, LLSV identified eight rules relating to shareholder protection: one share-one vote, proxy by mail, shares not blocked before meeting, cumulative voting or proportional representation, oppressed minorities mechanism,

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40. Rafael La Porta et al., *Judicial Checks and Balances*, 112 J. POL. ECON. 445, 451 tbl.1 (2004) [hereinafter, La Porta, *Judicial Checks and Balances*].

41. *Id.*

42. *Id.*

43. *See id.* at 469.

44. Beck et al., *supra* note 8, at 664.

45. Simeon Djankov et al., *Courts*, 118 Q.J. ECON. 453, 465 tbl.1 (2003) [hereinafter Djankov, *Courts*].

46. Beck et al., *supra* note 8, at 664.

47. Siems, *supra* note 32, at 398.

preemptive rights, percentage of share capital to call an extraordinary shareholders meeting, and mandatory dividends.<sup>48</sup> With one possible exception (minority oppression),<sup>49</sup> all of these topics are governed in the United States by statutory provisions, not by judge-made law. Therefore, if courts were the engines of adaptability, they would have only minimal influence over investor protection as initially conceived by LLSV.

After this initial effort was criticized for being too simplistic,<sup>50</sup> LLSV developed two new measures of shareholder protection. First, in *What Works in Securities Laws?*,<sup>51</sup> LLSV examined the role of securities laws in the issuance of new equity in public capital markets. They concluded that “securities laws matter,” and the securities laws that matter most are disclosure rules and anti-fraud rules.<sup>52</sup> These results are consistent with the expansive and evolving notion of “legal origins” that now informs Legal Origins Theory, namely, that “common law stands for the strategy of social control that seeks to support private market outcomes, whereas civil law seeks to replace such outcomes with state-desired allocations.”<sup>53</sup> Nevertheless, it is hard to discern a way in which they support the adaptability hypothesis. While private litigation may be an important avenue for fraud prosecution in common law countries, the legal rules governing fraud are generated almost exclusively by the Securities and Exchange Commission or trading organizations, such as the New York Stock Exchange. Simply stated, this rulemaking structure

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48. La Porta, *Law and Finance*, *supra* note 2, at 1122–23.

49. Minority oppression is often regulated through private litigation over common law fiduciary duties, but the exception is only “possible” because many states codify rules relating to minority oppression. For a description of the evolution of the cause of action of shareholder oppression, including both legislative and judicial developments, see Robert B. Thompson, *The Shareholder’s Cause of Action for Oppression*, 48 BUS. LAW. 699 (1993).

50. See, e.g., John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control*, 111 YALE L.J. 1, 4 n.6 (2001) (“By no means is it here implied that these rights are unimportant, but they seem to supply only partial and sometimes easily outflanked safeguards, which have little to do with the protection of control and the entitlement to a control premium.”).

51. La Porta, *What Works in Securities Laws?*, *supra* note 5.

52. *Id.* at 27–28.

53. La Porta, *Economic Consequences*, *supra* note 1, at 286. With respect to securities laws, LLSV reasons, “The benefits of common law appear to lie in its emphasis on private contracting and standardized disclosure and in its reliance on private dispute resolution using market-friendly standards of liability.” La Porta, *What Works in Securities Laws?*, *supra* note 5, at 28.

does not contemplate a special role for courts in improving the quality of law as “judges . . . react to changing circumstances.”<sup>54</sup>

A similar shortcoming with respect to the adaptability hypothesis afflicts the second new measure of shareholder protection, found in *The Law and Economics of Self-Dealing*.<sup>55</sup> In this article, LLSV construct an “index of the strength of minority shareholder protection against self-dealing by the controlling shareholder (*anti-self-dealing* index)”<sup>56</sup> based on variables developed from a survey of Lex Mundi law firms.<sup>57</sup> The authors point to the UK as the prototype of self-dealing regulation among common law countries, but the strength of the UK system does not reside in the courts. Indeed, LLSV observed that when courts were ineffective, “legislators stepped in to put constraints on self-dealing.”<sup>58</sup> Common law and civil law systems may exhibit a “pronounced difference” in shareholder protection,<sup>59</sup> but that difference for the most part does not reside in the use of courts.<sup>60</sup>

While many scholars other than LLSV have argued that legal origin is a viable proxy for “adaptability”—loosely defined—Legal Origins Theory seems to have no need for adaptability that emanates from courts. LLSV recognize this fundamental incoherence in the adaptability hypothesis, and they attempt to elide the problem by claiming that statutes are simply codifications of past judicial opinions.<sup>61</sup> While this is certainly true in some cases, including

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54. La Porta, *Economic Consequences*, *supra* note 1, at 305.

55. Djankov, *The Law and Economics of Self-Dealing*, *supra* note 5.

56. *Id.* at 432.

57. As noted by LLSV, “Lex Mundi is an association of international law firms with members in 108 countries.” *Id.* at 431.

58. *Id.* at 439.

59. *Id.* at 462.

60. But the authors observe, “The U.S. seems to be the exception, with its greater emphasis on ex post litigation rather than ex ante disclosure and approval.” *Id.* at 463. Given that self-dealing regulation in the United States is accomplished, to a great extent, by fiduciary duty litigation, we could imagine an adaptability story on this topic that cast courts in the leading role. While one would still have the burden of showing a connection between fiduciary law and economic outcomes, this does not seem like an implausible tale. Ironically, in the moment when we see an opening for the adaptability hypothesis, LLSV foreclose the possibility by concluding that courts are not an important part of self-dealing regulation in most of the world.

61. *See, e.g.*, La Porta, *Economic Consequences*, *supra* note 1, at 290 (“Statutes in common law countries often follow and reflect judicial rulings, so jurisprudence remains the basis of statutory law. Even when legislation in common law countries runs ahead of judicial law making, it often must coexist with, and therefore reflects, preexisting common law rules.”).

minority oppression statutes,<sup>62</sup> it is not true with regard to many rules examined in the foregoing articles. LLSV also claim that statutes in common law countries are less precise than their counterparts in civil law jurisdictions,<sup>63</sup> though this sounds like the generalization of a person who has never hefted a volume containing federal securities laws. Finally, in the ultimate bootstrapping argument, LLSV assert, “because legal origins shape fundamental approaches to social control of business, even legislation in common law countries expresses the common law way of doing things.”<sup>64</sup>

Even if we accepted the notion that all of the rules relating to shareholder protection identified by LLSV were dependent in some fundamental way on judicial action, the adaptability hypothesis would be woefully incomplete because it exaggerates the backward-looking nature of adaptability. Implicit in early attempts to think about the importance of adaptability to economic development is the idea that law is reflexive. While judges certainly consider the prospective effects of their rulings, the principal orientation of courts is backward looking. Legislatures and regulatory agencies, on the other hand, tend to make laws in anticipation of future events, albeit with an eye on the lessons learned in the past. While legislators and bureaucrats may be responding to past factual developments, the principal orientation of legislatures and regulatory agencies in rule-making mode is forward looking.

Law typically adapts both through backward-looking and forward-looking actions. For example, changes in the shareholder census in the United States over the past several decades and the resulting increase in shareholder activism have prompted various innovations in private ordering,<sup>65</sup> litigation,<sup>66</sup>

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62. Thompson, *supra* note 3.

63. See, e.g., La Porta, *Economic Consequences*, *supra* note 1, at 291 (“[S]tatutes in common law countries are often highly imprecise, with an expectation that courts will spell out the rules as they begin to be applied.”).

64. *Id.*

65. The rise of corporate governance ratings agencies is one important manifestation of private ordering as a result of increased shareholder activism. On the dubious quality of such ratings, see Robert Daines et al., *Rating the Ratings: How Good Are Commercial Governance Ratings?* (John M. Olin Program in Law & Econ., Stanford Law Sch., Working Paper No. 360, 2008), available at <http://ssrn.com/abstract=1152093>.

66. Shareholders have been actively pursuing more expansive participation in corporate governance through innovative lawsuits. See, e.g., *Bebchuk v. CA, Inc.*, 902 A.2d 737 (Del. Ch. 2006) (relating to a shareholder-proposed bylaw limiting the duration of a board-authorized rights plan to one year); *Am. Fed’n of State, County, and Mun. Employees v. Am.*

regulation,<sup>67</sup> and legislation.<sup>68</sup> These changes are part of an iterative process, with law responding to changes in facts and facts responding to changes in law.

The foregoing analysis reaffirms that adaptability is an attribute of all legal institutions. This insight implies the need to channel legal reforms to the institution that is best equipped to provide such reforms.<sup>69</sup> LLSV favor legal systems that channel a higher percentage of reforms through courts because “the ability of judges to react to changing circumstances—the adaptability of common law—tends to improve the law’s quality over time.”<sup>70</sup> On the other hand, legislatures and regulatory agencies may have a better capacity to make wide-ranging policy decisions.<sup>71</sup> We see no reason *a priori* to favor one form of adaptation over the other, and we believe that Legal Origins Theory favors courts primarily because this view provides an *ex post* justification for the observation that economic outcomes tend to be more favorable in common law countries than civil law countries.<sup>72</sup>

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Int’l Group, Inc., 462 F.3d 121 (2d Cir. 2006) (relating to a shareholder-proposed bylaw permitting shareholder-nominated candidates to be included on the corporate ballot).

67. The Securities and Exchange Commission has proposed “changes to the federal proxy rules to remove impediments to the exercise of shareholders’ rights to nominate and elect directors to company boards of directors.” Securities Release No. 33-9046, June 10, 2009, “Facilitating Shareholders Director Nominations,” available at <http://www.sec.gov/rules/proposed/2009/33-9046.pdf>.

68. Delaware recently amended the General Corporation Law to allow a corporation to adopt a bylaw that would require the corporation to include shareholder nominees for director positions on the corporation’s proxy statement, subject to limitations set forth in the bylaws. DEL. CODE ANN. tit. 8, § 112 (2009).

69. See Katharina Pistor & Chenggang Xu, *Incomplete Law*, 35 INT’L L. & POL. 931 (2003); Katharina Pistor & Chenggang Xu, *Fiduciary Duty in Transitional Civil Law Jurisdictions: Lessons from the Incomplete Law Theory* (European Corporate Governance Institute, Working Paper No. 01/2002), available at [http://ssrn.com/abstract\\_id=343480](http://ssrn.com/abstract_id=343480).

70. La Porta, *Economic Consequences*, *supra* note 1, at 305.

71. The relative competencies of legislatures, agencies, and courts have occupied many volumes of legal scholarship. We need not attempt to synthesize that learning here, where the point is simply that legislatures and agencies may be in a better position to adapt than courts. See, e.g., Louis Kaplow, *Rules versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 608, 616–17 (1992) (“Legislatures may be better equipped to draw upon technical expertise than courts,” and while “[l]egislatures were intentionally devised to make changing laws difficult (absent rather broad agreement on the need for change) . . . , a legislature can delegate rulemaking authority to an agency, so that rules may be changed more readily.”).

72. In an important study of procedural formalism in courts, LLSV observe that many institutions—including reputations, informal discussions, regulatory agencies, and courts—secure property and enforce contracts, but “[e]conomic theory does not tell us which of these . . . is the best.” Djankov, *Courts*, *supra* note 45, at 454. Although many economists

## V. CONCLUSION

The impossibility of measuring adaptability directly has prompted Legal Origins Theory to rely on the role of the courts as a proxy for adaptability. We have argued that this argument fails to connect with the differences in substantive law that—according to LLSV—are responsible for the competitive advantage of common law jurisdictions. For the time being, adaptability in Legal Origins Theory is a theoretical construct, not an empirical concept. An alternative empirical approach might start from the premise that the more adaptable a jurisdiction becomes the less predictable it is. Indeterminacy of the law could thus serve as a proxy for adaptability (responsiveness). A recent study comparing the degree of indeterminacy of corporate fiduciary duties in Delaware, the United Kingdom, and Germany concludes that German law seems to rely more on indeterminate standards than the two common law jurisdictions.<sup>73</sup> This first piece of evidence runs against the notion that common law courts are more ready to adapt the law to changing circumstances. As it stands, the adaptability hypothesis is still a far cry from conclusively explaining the superiority, real or alleged, of the common law.

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have assumed that courts are the best institution for securing property and enforcing contracts, LLSV found that “even . . . simple disputes are resolved extremely slowly by courts in most countries,” though the results show “huge variation among countries in the speed and quality of courts.” *Id.* The key factor driving delays is “procedural formalism,” and LLSV argue that less procedure generally leads to more efficiency. *Id.* at 511.

In another line of research on courts, Edward Glaeser and Andrei Shleifer argue that judicial independence is one of the defining characteristics of the common law. Edward L. Glaeser & Andrei Shleifer, *Legal Origins*, 117 Q.J. ECON. 1193 (2002). In a later empirical study of judicial independence, LLSV find that “judicial independence is empirically strongly associated with common-law legal origin and is itself a strong predictor of some of the same economic freedoms as common law.” La Porta et al., *Judicial Checks and Balances*, *supra* note 40, at 449. Thus, “judicial independence accounts for some . . . of the beneficial effects of common law on economic freedom.” *Id.*

Both of these lines of research suggest that common law courts are better than civil law courts in ways that matter to economic development, but neither line of research tells us that courts are better able to promote adaptability than other legal institutions.

73. Jens Dammann, *Regulatory Competition and Legal Determinacy in Corporate Law* (Univ. of Tex. Law Sch. Law and Econ. Res. Paper No. 166, 2009), available at <http://ssrn.com/abstract=1491864>.