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Innovation in corporate law

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In most countries large business enterprises today are organized as corporations. The corporation with its key attributes of independent personality, limited liability and free tradeability of shares has played a key role in most developed market economies since the 19th century and has made major inroads in emerging markets. We suggest that the resilience of the corporate form is a function of the adaptability of the legal framework to a changing environment. We analyze a country's capacity to innovate using the rate of statutory legal change, the flexibility of corporate law, and institutional change as indicators. Our findings suggest that origin countries are more innovative than transplant countries. *Journal of Comparative Economics* **31** (4) (2003) 676–694. Columbia Law School, 435 West 116th Street, New York, NY 10027, USA; University of Michigan, Ann Arbor, MI, USA; Ernst & Young, Washington, DC, USA; Max Planck Institute for Foreign and Comparative Private Law, Hamburg, Germany.

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1. Introduction

Corporate law and corporate governance are used in recent literature to explain differences in the performance of financial markets and firms. The objective of this

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research is to identify variables that account for differences in performance and to rectify deficiencies in corporate law and financial market development by changing these variables. Attempts to identify best legal practice and to develop legal standards that may be transplanted are endorsed by multinational institutions, such as the IMF and the World Bank (Pistor, 2002). This strategy receives empirical support in studies showing that the level of minority shareholder protection in laws on the books does indeed have a statistically significant impact on the development of financial markets as measured by standard indicators, such as market capitalization, liquidity, and the ownership concentration of firms (La Porta et al., 1997, 1998). These studies find that countries belonging to the common law family have better minority shareholder protection on average than countries belonging to the German, French or even the Scandinavian civil law family. They also show that common law countries have better developed financial markets than do civil law countries.

Implicit in this analysis is a causal relation that runs from legal origin to the quality of law to financial outcome. However, a brief review of the history of corporate law in the mother country of the common law, England, shows that only a few of the indicators that account for the high level of minority shareholder protection in common law countries as measured in these studies were present at the time the first corporate statutes were enacted as Table 1 indicates.

This observation raises the issues of why some countries have developed these protective mechanisms while others have not and whether a set of static indicators can serve as a proxy for the quality of law. In this paper, we propose an alternative approach to assessing the quality of corporate law, namely, the capacity of a legal system to innovate. The more innovative and adaptable a legal system is, the more likely it is able to respond to a changing environment and thereby give firms the possibility to explore new opportunities while ensuring a minimum level of investor protection.

Table 1
Minority shareholder protection in English law

	Date of enactment	Comment
Proxy by mail	1948	Prior to 1948, shareholders could vote by proxy only if this had been stipulated in the articles of incorporation; no mention is made of proxy by mail.
Cumulative voting	(–)	(–)
No blocking of shares	(–)	(–)
Shareholder suit	1844	Direct suit implied in 1844; derivative action recognized only in 1975.
Preemptive rights	1980	Adopted in response to EU harmonization requirements.
Shareholders representing not more than 10 percent of total stock can call extraordinary shareholder meeting	1909	The 1862 law required 20 percent. The threshold was lowered to 5 percent in 1948.

Note. (–) denotes that the relevant provision does not exist in the statutory corporate law.
Source. English Companies Acts 1844 to present.

We use data on the evolution of corporate law in ten jurisdictions to explore this proposition. Each of the major legal families, namely, the common law family and civil law families of France and Germany, are represented. For each family, we include origin countries, i.e. countries that developed their formal legal systems largely internally or with only limited borrowing, as well as transplant countries, i.e., those that received their formal legal order from foreign sources. The four origin countries are France, Germany, England, and the United States.[1] The six transplant countries are Spain, Chile and Colombia belonging to French civil law, Japan belonging to the German civil law, and Israel and Malaysia belonging to the common law families.

We find substantial differences in the capacity of legal systems to innovate along three dimensions, namely, the rate of statutory legal change, the flexibility of corporate law, i.e., enabling vs. mandatory, and the development of new enforcement mechanisms. First, our findings suggest that the rate of statutory legal change is substantially higher in origin countries than in transplants. Although common law countries have had a somewhat higher rate of change than civil law countries among the four origin countries, the difference between origins and transplants within each legal family is greater than the differences across legal families. Second, countries with a highly mandatory statutory law exhibit less innovation than countries with a more enabling statutory law. Third, legal institutional innovation, in particular, the creation of new enforcement agents such as regulators, has been higher in countries with a more enabling corporate law than in those with a highly mandatory law.

Our evidence is drawn from statutory corporate law provisions on issues related to corporate finance. In parallel work, we investigate corporate law more broadly and include the governance structure of the firm as well as the rules governing entry and exist (Pistor et al., 2002). However, it is in corporate finance law where we find both the greatest difference across jurisdictions and the greatest rate of innovation over time.

In Section 2 of this paper we explain the meaning of legal innovation and develop a set of propositions to assess the innovative capacity of different legal systems. In Section 3 present the evidence we find in the ten countries included in the analysis. Section 4 concludes.

2. Legal innovation and propositions

Our major proposition is that the capacity of legal systems to innovate is more important than the level of protection a legal system may afford to particular stakeholders at any point in time. Minimum protections may be taken as a first indicator to assess the quality of legal systems. However, such protections may soon be out of date, as changes in the environment or the capacity of economic agents to circumvent established rules and to develop new forms of arbitrage will render previously effective protective mechanisms ineffective. This is true especially in areas such as corporate law and financial market regulation because socioeconomic and technological change is rapid and challenges the

[1] Whether the US is a transplant or origin country may be disputed. The US received the common law system by way of transplantation from England. However, since the late 18th century, the legal evolution in the US has been sufficiently idiosyncratic (Horwitz, 1977) to justify its classification as an origin country.

legal system persistently. The recent wave of financial accounting frauds in the US, a legal system that has been hailed as the most advanced system with regard to financial market regulation, illustrates that innovative capacity is a continuous challenge.

Innovative capacity does not specify the type of legal protections different legal systems should adopt or the institutions they should establish. In fact, innovative capacity refers to a given system's ability to respond to the challenges it faces, which may well differ from those faced by a neighboring system. Therefore, we are not interested in a set of best practice indicators but, in legal change that responds to country or system specific problems. Moreover, we do not limit legal change to changes in the law on the books, although data availability implies that this is the least difficult case to establish; rather, we include indicators for the flexibility of corporate law and institutional change respectively.

Hayek (1973) emphasizes the importance of legal evolution and change and points out that judge made law is evolutionary by nature. Statutory law enacted by legislatures may be swifter at times and may serve to correct judge-made law, but statutory law may also be used to restrict innovation and to infringe on individual liberties. Several authors argue that the common law is efficient, because the process of lawmaking by judges on a case by case basis lends itself to efficient rule selection (Priest, 1977 and Rubin, 1977). However, a potential selection bias affects litigation as Bailey and Rubin (1994) argue. Finally, a comparative legal analysis emphasizes the differences between code and case law in bringing about legal change (Merryman, 1985; Merryman, 1996, and Zweigert and Kötz, 1998). Building on this literature, Beck et al. (2003) use case law, defined as a dummy variable that indicates whether judicial decisions are a source of law, in addition to requirements that statutory law rather than principles of equity are a basis for court rulings as proxies for the adaptability of legal systems. Our approach differs in several respects. The focus of our analysis is on the law governing the corporate enterprise. Corporate law has been codified in all major jurisdictions, including the common law families, since the early 19th century. Therefore, we treat statutory law as an important source of information for the innovative capacity of legal systems. In particular, we use the rate of statutory legal change since the first enactment of a formal corporate law as a proxy for legal innovation.

Given the importance of statutory corporate law in all jurisdictions, the simple distinction between case law and statutory law is unlikely to capture major differences across legal families. Therefore, we classify corporate laws on the continuum from mandatory to enabling corporate law following Coffee (1989) and Gordon (1989). Mandatory law means that private agents may not opt out of the allocation of control rights prescribed in the statutory law. By contrast, an enabling law makes most of the statutory provisions optional and allows parties to reallocate control rights. The classification of a corporate law as enabling or mandatory has important implications for the relevance of judge-made law. When law is mandatory, judges may be called upon to enforce these rules but they have comparatively little lawmaking functions because the mandatory nature of the law implies that these functions are reserved for the legislature. When law is enabling or optional, judges play an important role in determining the boundaries of the permissible reallocation of control rights and in settling disputes among private actors with different claims to control rights.

This classification allows us to distinguish between legal systems that belong to the same legal family. In particular, we show that there are important differences within the common law family in the mandatory vs. enabling dimension. The law in Delaware, which is the leading jurisdiction for corporate law within the US, represents a highly enabling corporate law. However, England, as well as Malaysia and Israel are located somewhere in the middle of a continuum from mandatory to enabling law. The classification also leads us to reject the proposition by Beck et al. (2003) that Germany falls within the case law category. In many areas of the law e.g., contracts and torts, judges in Germany carry out important lawmaking functions, but this is not the case for the law governing the publicly traded corporation (*Aktienrecht*). German corporate law is highly mandatory[2] so that case law is virtually absent. Indeed, corporate law textbooks suggest that, because of the scarcity of case law in this area, it is sufficient to read the provisions of the statute (Kübler, 1994).[3]

Our third indicator of innovative capacity is legal institutional change. The development of stock markets has been accompanied by the emergence of new lawmaking and law enforcement institutions in the form of regulators, i.e., stock exchanges and state regulators such as the Securities and Exchange Commission (SEC) in the US and the Financial Services Authority (FSA) in the UK (Coffee, 2002). Recent work attributes the emergence of financial market regulators to the failure of courts to enforce the law effectively enough to deter stock and corporate fraud. Glaeser and Shleifer (2003) argue that this failure in the US in the early 20th century is due to the fact that the judiciary was captured by powerful industry groups, which necessitated the creation of a new independent state agent. Pistor and Xu (2003a) suggest that, even if courts are impartial, the design of courts as neutral arbiters implies that courts can enforce the law only reactively, i.e., after the victim or a state agent have brought action. This limits their capacity to prevent harmful actions from taking place. By contrast, regulators are designed to initiate law enforcement independently, which places them in a better position to prevent harmful actions from occurring. Tentative support for the latter proposition is found in La Porta et al. (2002), who suggest that criminal sanctions administered by courts are less important than the existence of a financial market regulatory or supervisor for the development of securities markets.

These three indicators of innovative capacity are not independent of each other. A highly mandatory corporate law limits the ability of private actors to reallocate rights and also limits the scope of judge-made law. The lack of private innovation and judge-made law may also affect adversely the rate of statutory legal change. This may be somewhat counterintuitive because statutory legal change can serve to implement radical legal change almost immediately. However, to the extent that statutory law limits the ability of private actors to experiment with new legal forms and restricts the courts' ability to review these experiments, it limits the source of legal innovation to the legislature. Kaplow (1997) argues that legislatures can collect relevant information that would allow them to assess the demand for legal change. From this perspective, limiting the source of innovation to the legislature may not impede innovation. However, litigation may be superior to survey work

[2] According to para. 23 V Aktiengesetz (Law on Joint Stock Companies) all provisions of the law are mandatory, unless explicitly stated otherwise in the law.

[3] The situation is quite different for closely held corporations (GmbH), for which courts play a very active role. The reason for the lack of case law governing the *Aktiengesellschaft* (AG) is widely attributed to the lack of procedural rules that would allow shareholders to take judicial recourse.

in revealing critical information that may prompt a reversal in case law or an intervention by the legislature.

Conversely, a highly enabling law that gives private actors substantial discretion in allocating and reallocating control rights among themselves requires an effective neutral arbiter to resolve disputes among competing claims. The more innovations by private actors, the more difficult it is for courts to keep up with the pace of change and the more likely it is that legal systems will suffer from deterrence failure (Xu and Pistor, 2002). Therefore, highly enabling laws governing the corporate enterprise may result in market collapse, unless the legal system has sufficient capacity to create new institutions to make up for the deficiencies in law enforcement. Put differently, a highly enabling law provides a fertile ground for legal innovation. Unless a legal system proves capable of responding to the new challenges arising from legal innovation, this strategy may be self-defeating. The following propositions are derived from the above analysis. First, the more mandatory is a corporate law, the less legal innovation will take place. Second, the more enabling is a corporate law, the more legal innovation will take place. Third, the more enabling is a corporate law, the greater is the need for institutional innovation, in particular for new law enforcement agents.

We recognize that there may be different factors influencing the innovative capacity of legal systems. The constitutional system, including the allocation of legislative powers and the ease with which rulemaking powers can be delegated to other agents, e.g., regulators, may influence the responsiveness and innovativeness of legal systems. Moreover, political factors may hinder or support legal reform in corporate law. Colombia's problems in maintaining political stability and fighting drug trade may have prevented a more proactive stand on issues related to matters of corporate law. We do not address these broad political and constitutional factors because they are beyond the scope of this research project. However, we do include a country's history in developing its formal legal order into our analysis. Berkowitz et al. (2003) suggest that countries that have imported their formal legal order, rather than having developed it internally may suffer from the transplant effect. These authors show that legal transplants have weaker legal institutions than origin countries. In explaining their findings, they suggest that the transplant countries may lack a demand for the legal order that is superimposed on them; therefore, their governments may decide not to invest in institutions necessary to implement this order. Hence, we assert a fourth proposition that legal transplant countries reveal less innovative capacity as indicated by the rate of legal change than do legal-origin countries.

3. The data and the indicators of innovative capacity

We include ten countries in our analysis, of which four origin countries represent the major legal families of common law, French civil law, and German civil law and six are transplant countries. We select the leading countries for each legal family and add 1–3 transplant countries to each family. The selection of transplants is guided primarily by the expertise of the authors. While we recognize the problems involved in not using more objective criteria for sampling purposes, our research involved a large amount of legal analysis, for which some familiarity with the legal systems appeared to be sufficiently important to overrule those concerns.

We code legal change from the first enactment of formal corporate statutes until the end of 2000. We note two important observations at the outset. First, the earliest statutory laws of the four origin countries did not differ much from one another. All were rather short and paid little attention to the internal governance structure of the corporation, to corporate finance, or to the transfer of corporate control. They focused primarily on the formation of the corporation, the activities it could undertake, and the distribution of assets upon dissolution. Second, when law was transplanted, it was usually the most up-to-date version of the corporate law. Thus, in theory, transplant countries had the chance to bridge the gap and catch up with legal developments in origin countries.

Regarding the contents of corporate law, our primary focus is on changes in the law that pertain to corporate finance, including provisions governing legal capital, changes in corporate capital, procedures for issuing shares, preemptive rights, and repurchase of shares. The major advantage of the publicly held corporation is that it can raise funds from a broad base of investors. Moreover, corporate finance rules play a crucial role in structuring mergers and takeovers, which are important features of the market for corporate control. In parallel work, we investigate the internal governance structure and rules on entry and exit of the firm (Pistor et al., 2002). We find that legal systems differ most substantially in the area of corporate finance, which makes this a fruitful area in which to analyze the scope of legal innovation.

To determine whether corporate law is mandatory or enabling, we analyze the allocation of control rights with regards to core provisions of corporate finance in statutory law. Table 2 contains a brief definition of the variables and indicates the type of rule that we consider mandatory or enabling.

Table 2
Definition of corporate finance indicators

Indicator	Definition	Mandatory	Enabling
Legal capital	Minimum amount shareholders must contribute when establishing the corporation	Minimum capital or minimum par value of shares is determined in statutory law	No minimum capital provision in statutory law and/or corporation may issue shares without par value
Capital increase and decrease	Provisions determining who may decide on changes in corporate capital and what majority requirements must be met for valid decision	Unanimous or supermajority vote by shareholders is required	Majority shareholder vote is sufficient; higher requirements may be stipulated in corporate charter
Authorized, unissued capital	Once shareholders have authorized the issuance of new shares, directors may determine when and at what price to issue them	Authorized stock is not provided for or prohibited	Directors may determine the timing and pricing of share issuances
Preemptive rights	Right of existing shareholders to buy newly issued shares in proportion to their current holdings	Newly issued shares must be offered first to existing shareholders	For shareholders to have a preemptive right, the corporate charter must stipulate it explicitly
Repurchase of shares	The company has the right to buy its own stock	The company may not buy its own stock except in cases enumerated in statutory law	The company may buy its own stock subject only to rules guarding against capital depletion

Table 3 contains the allocation of control rights over these issues for the ten countries in our sample. These countries fall into three broad categories, namely, countries with a highly enabling corporate law, those with a moderately enabling corporate law, and those with a mandatory corporate law.

Delaware is the only country that fits perfectly into the first group of highly enabling statutory corporate law. It leaves the allocation of control rights over most finance issues to corporate stakeholders. While the first corporate statute of 1883 in Delaware and several

Table 3
Changes in legal provisions on corporate finance

Country	1900	1950	2000
Delaware			
Legal capital	Nominal value stipulated in corporate charter	Shares may be issued without par value	x
Capital decrease	2/3 Shareholder vote	Shareholder majority vote	Directors may retire unissued or repurchased stock
Capital increase	2/3 Shareholder vote	Shareholder majority vote; directors may decide to set aside net assets	x
Issue of authorized stock	(–)	Directors may issue authorized stock	x
Preemptive rights	(–)	Corporate charter may restrict preemptive rights	Preemptive rights only if stipulated in corporate charter
Share repurchase	Repurchase implied	Repurchase by directors' decision; guidelines for prices	x
UK			
Legal capital	Nominal value stipulated in corporate charter; no issue below par	x	Minimum capital requirement
Capital decrease	3/4 Shareholder vote	x	x
Capital increase	3/4 Shareholder vote	x	x
Issuing authorized stock	Directors may issue authorized stock	x	x
Preemptive rights	(–)	x	Preemptive rights may be waived
Share repurchase	Corporate charter determines conditions	x	x
France			
Legal capital	Minimum share value stipulated by law; no issue below par	x	x
Capital decrease	Board resolution and 2/3 shareholder vote	x	x
Capital increase	Board resolution and 2/3 shareholder vote	x	x
Issuing authorized stock	No	No	Board may issue authorized stock; price adjustment must be approved by shareholders

(*continued on next page*)

Table 3 (*Continued*)

Country	1900	1950	2000
Preemptive rights	(–)	Shareholders have preemptive rights that may be waived for placement with specified investor	Preemptive rights may be waived without specifying placement for 2 years; shareholders must approve changes in price
Share repurchase	No	No	Special prospectus and clearance from regulator required
Germany			
Legal capital	Nominal share value stated in law; no issuance below par	x; Minimum capital requirement	x
			x
Capital decrease	3/4 Shareholder vote	x	x
Capital increase	3/4 Shareholder vote; increase only after original contributions fully paid in	x	x
Issuing authorized stock	No	Directors may issue authorized shares within 5 years	x; 3/4 of capital must be present at the shareholder meeting that authorizes capital
Preemptive rights	Preemptive rights granted by law; may be waved	x; 3/4 shareholder vote to waive preemptive rights	x
Share repurchase	Only in context of formal capital reduction and if provided in charter	x	Shareholders may authorize repurchase a maximum of 10% of total stock for 18 months
Israel			
Legal capital		Nominal share value stated in corporate charter	x
Capital decrease		3/4 majority shareholders vote	Simple majority shareholder vote
Capital increase		3/4 majority shareholders vote	Simple majority shareholder vote
Issuing authorized stock		(–)	(–)
Preemptive rights		(–)	Preemptive rights may be waived
Share repurchase		No repurchase	Repurchase allowed under conditions stipulated in law

(*continued on next page*)

subsequent revisions included a number of mandatory provisions, corporate law became increasingly more enabling. Most of these changes were accomplished by the late 1920s. For example, statutory nor case law stipulated the appropriate level of capital that had to be contributed at the time the company was founded. This rather broad formulation left it up to both corporate stakeholders and courts to determine the appropriate level of capital on a

Table 3 (*Continued*)

Country	1900	1950	2000
Malaysia			
Legal capital		Nominal share value stated in corporate charter	x
Capital decrease		3/4 shareholder vote	Simple majority shareholder vote
Capital increase		3/4 shareholder vote	Simple majority shareholder vote
Issuing authorized stock		Not addressed	Shareholder vote required
Preemptive rights		(–)	x
Share repurchase		Prohibited	Permitted to reduce capital
Japan			
Legal capital	Minimum par value stipulated in law	x	x; Minimum capital requirements
Capital decrease	Simple majority vote	x; (quorum raised from 50% to 2/3)	x
Capital increase	Simple majority vote	x; (quorum raised from 50% to 2/3)	x
Issuing authorized stock	(–)	Directors may issue authorized stock	x
Preemptive rights	(–)	Available, if stipulated in corporate charter	Board may stipulate right with each new issuance
Share repurchase	Prohibited	Prohibited with exception of share amortization, merger, enforcement of rights, and payment of appraisal rights to dissenters	x; exception extended to employee and management stock option for up to 10% of corporate capital if exercised within 10 years
Spain			
Legal capital	Registering authority assesses adequacy	x	Minimum capital stated in law
Capital decrease	Unanimous decision	x (2/3 at second meeting)	x
Capital increase	Unanimous decision	x (2/3 at second meeting)	x
Issuing authorized stock	(–)	x	x
Preemptive rights	(–)	Preemptive rights established	Preemptive rights may be waived by super-majority vote
Share repurchase	Prohibited	x	Exemptions apply to employee and management stock option plans

(*continued on next page*)

case-by-case basis. In 1929, the supermajority requirement for changes in corporate capital was reduced to simple majority. Thus, the legislature signaled that minority shareholders would not be able to veto changes in corporate capital. Creditors were not protected in corporate law; rather they had to protect themselves through contractual covenants. Measures that could affect creditors, e.g. the redemption and retiring of shares, were left to the board to decide. Directors also obtained the right to determine the timing of issuing

Table 3 (*Continued*)

Country	1900	1950	2000
Chile			
Legal capital	Minimum capital fixed by government	Minimum capital stipulated in law	Minimum capital must be adequate for operation
Capital decrease	Prohibited	Subject to approval by government	2/3 majority shareholder vote
Capital increase	Unanimous vote	x	2/3 majority shareholder vote
Issuing authorized stock	(–)	(–)	(–)
Preemptive rights	(–)	x	Preemptive rights granted by law
Share repurchase	Prohibited	x	x
Colombia			
Legal capital	Minimum capital fixed by government	x	x
Capital decrease	Prohibited	x	70% majority shareholder vote and government approval
Capital increase	Unanimous vote	x and government approval	70% majority shareholder vote and government approval
Issuing authorized stock	(–)	x	x
Preemptive rights	(–)	Preemptive rights granted by law	x; exclusion only with government approval
Share repurchase	Prohibited	x	x

Note: x denotes no change to previous column. (–) indicates that the relevant provision does not exist in the statutory law of that country.

authorized stock and the pricing thereof. At the same time, shareholders' preemptive rights were curtailed. Whereas in the early 19th century, courts held that preemptive rights were a fundamental right of shareholders, the desire to use shares more flexibly as part of control transactions or to access new markets took precedence over these more traditional concerns. Since 1927, Delaware law allows corporations to restrict preemptive rights and, as of 1967, preemptive rights must be stipulated explicitly in the corporate charter or shareholders do not possess this right.

Corporate law in England never achieved the same level of flexibility. Therefore, we place England together with Malaysia and Israel in the group of moderately enabling corporate law. In fact, contrary to the general trend from a more mandatory to a more enabling corporate law that we observe in most countries in this group, England has included provisions on minimum corporate capital and mandatory preemptive rights only in 1980. This was in response to EU harmonization requirements and does not necessarily reflect a shift in England's general approach to corporate law. If we ignore these imposed changes, English corporate law has remained remarkably stable. The law set broad limits on the allocation of control rights, but left it up to corporate stakeholders to change them within these limits. As a result, shareholders remain firmly in control of most decisions.

Unlike in Delaware, shares must be issued at par value and changes in corporate capital still require a supermajority vote of 3/4. However, the corporate charter was left to determine the conditions for repurchasing company shares and, as mentioned already, preemptive rights did not exist in England before it joined the EU.

The two transplant countries in the common law family, Israel and Malaysia, are relatively close to the English case. Israel received English corporate law in 1929 and the first major revision in 1983 retained most of the characteristics of English law. However, the 1999 revision suggests that Israel is moving closer to the Delaware model. In particular, the voting requirement for changes in corporate capital have been lowered to simple majority vote and preemptive rights may be waived at the time the shareholders vote on the issuance of new shares. Part of the territories that comprise Malaysia received English law during the late 19th century. Similar to Israel, the consolidated territory of Malaysia received the 1928 English Companies Act in 1929. In 1965, Malaysia revised the law following the Australian model which is itself a copy of English law and has revised this statute several more times. Although Malaysia has followed the Delaware model regarding decisions on changes in corporate capital, it requires a special shareholder vote for issuing authorized capital. Furthermore, Malaysia allows share repurchase only for the purpose of reducing corporate capital, to buffer steep declines in share prices, as an alternative to dividend payment, or as a defensive strategy in a takeover contest.

The third group includes countries in which corporate law mandates the allocation of control rights traditionally and gives corporate stakeholders very little flexibility to reallocate them. There are signs that flexibility is increasing because the law grants more exemptions to mandatory provisions. However, the general position that lawmakers, not stakeholders, determine the allocation of control rights remains largely unchanged. Germany and France, as well as the transplant countries of these legal systems, fit into this category. In 1870, Germany liberalized the entry requirements for corporations by moving from the concession to the registration system. This change occurred twenty-six years after England had made this move, and three years after France had taken a similar decision. Subsequently, Germany experienced a major founders' boom, followed by a crash. The government's response was to tighten entry requirements once more and to protect small investors by effectively preventing them from investing in large publicly traded corporations. The new law of 1884 mandated that the nominal value and minimum price for each newly issued share was 1000 Reichsmark (RM), which was well beyond the capability of small investors to pay (Reich, 1976). In addition, the law required that all original contributions be fully paid up before the corporation was registered.

In the next major revision of Germany's corporate law in 1937, legal capital was introduced and any change in corporate capital required a three-quarter majority. The 1937 revision also introduced authorized but unissued capital but, the board could exercise the right to issue this type of stock only for a period of up to 5 years. Stock repurchase by the corporation was prohibited in 1870; in 1884, it was allowed only for the purpose of decreasing corporate capital. In 1937, the prohibition to repurchase stock was relaxed so that the corporation could repurchase up to 10 percent of its corporate capital, but only for purposes enumerated in the law. In 1965, the list of exemptions from the prohibition to repurchases was extended to include employee stock plans and repurchases for raising cash funds to buy out shareholders with put options. Since 1998, management stock option plans are also exempted. To prevent misuse of this new flexibility, the law stipulates that repurchasing shares is not allowed for the sole purpose of trading in the company's own shares.

Preemptive rights became mandatory in Germany in 1897. Shareholders are in principle allowed to waive them at the shareholder meeting during which the capital increase is decided. However, case law established that such a decision is valid only, if the allocation of these shares can be specified sufficiently at the time so that shareholders can weigh their options.[4] For cases in which the purpose of the new issuance was to place shares on international markets or to use them as currency for future merger, i.e., transactions that are highly contingent on a number of conditions that are difficult to specify ex ante, this requirement proved difficult to satisfy. The German Supreme Court upheld this line of reasoning until the 1990s, when the first signs of a change in opinion appeared in a case involving Deutsche Bank.[5] Finally, the court put aside the specification requirement in 1997 and accepted a waiver of preemptive rights on the grounds that the shares could be used for future control transactions.[6] This decision came over seventy years after Delaware enacted an amendment giving shareholders the right to restrict preemptive rights in the corporate charter.

The development in France parallels that in Germany. The relaxation of statutory provisions has often been accompanied by conditions that limit the newly gained flexibility. For example, although directors have the right to issue authorized stock, shareholders have to approve any change in the price at which stock is issued. Similarly, it has been possible to waive preemptive rights since 1950, but only for specific purposes. Recently, this conditionality has been loosened by allowing directors to issue shares within two years after authorization without a specific purpose. However, changes in price still require shareholder approval.

Japan is also closer to the German model than to the Delaware one, despite having a US style corporate law on the books since 1950 (West, 2001). Minimum capital requirements were introduced only recently. Shares repurchase remains restricted, even though the list of exemptions has increased. The only issue on which the law is more flexible than the German law is preemptive rights. Directors may stipulate preemptive rights with each new share issue. Spain also fits into the third group of countries. This classification may be due to a path dependent legal development because Spain borrowed extensively from France in the nineteenth century. In addition, Chilean law falls into this category. Although revisions in 1981 and subsequent years were influenced strongly by US law, Chilean law remains to this day much more mandatory than the laws of Delaware or other common law jurisdictions in our sample. Thus, changes in corporate capital still require supermajority vote and unissued authorized stock is not provided by law. Furthermore, preemptive rights are mandatory and the repurchase of shares remains prohibited. Earlier law in Chile and

[4] German Supreme Court (BGH) of 13 August 1978, published in Neue Juristische Wochenschrift (NJW) 1978, p. 1316 (Kali-Salz). See also the Holzmann decision, German Supreme Court (BGH) of 19 April published in NJW 1982, p. 2444.

[5] German Supreme Court (BGH) of 7 March 1994, published in NJW 1994, p. 1410 (Deutsche Bank).

[6] BGH, 23. 6. 1997–II ZR 132/93, published in NJW 2997 (42) p. 2815.

Colombian law was even more restrictive in that it allocated a number of important control rights explicitly to government agents rather than to corporate stakeholders. In 1854, Chilean law required two separate presidential decrees for establishing a corporation and any decrease in corporate capital was subject to government approval. Moreover, the registering authority stipulated the amount of legal capital at the time of incorporation. State control rights have been equally common in Colombia since that country copied Chilean law in 1887; many of these statutes are still on the books today.

This brief overview suggests that the sample consists of two outliers, namely, Delaware on the flexible end of the spectrum and Colombia on the restrictive side. The remaining eight countries fit somewhere in the middle. England and English transplant countries are somewhat closer to Delaware. Although Japan received US-style corporate law in 1950, albeit from Illinois and not from Delaware as West (2001) asserts, the country has remained more faithful to the civil law tradition from which it original borrowed its institutions.

The rate of legal change is a simple measure of the frequency of statutory legal change over the course of a law's lifetime. To compute the rate of legal change, we include all major statutory changes, not only those that address corporate finance issues. Major legal change is defined as a substantive change of legal provisions, beyond editorial changes or changes to ensure consistency with other legal reform projects. While judgment is required, we find little dispute in secondary sources in any of the countries over the dates when important changes in, or revisions of, corporate law occurred. Table 4 documents the dates of major legal changes in corporate law in the ten countries.

Table 4
Legal changes in statutory corporate law

France	Germany	UK	US	French tr.			Germ. tr.	English tr.	
			Del.	Spain	Chile	Colombia	Japan	Israel	Malaysia
1807	1861	1844	1883	1829	1854	1853	1899	1929	1929
1856	1870	1862	1899	1848	1865	1887	1938	1968	1965
1867	1884	1867	1901	1868	1878	1888	1950	1983	1972
1907	1897	1877	1917	1869	1924	1898	1952	1986	1983
1931	1931	1879	1927	1885	1929	1931	1955	1999	1985
1935	1937	1880	1929	1919	1931	1950	1966		1987
1937	1965	1890	1931	1942	1947	1971	1969		1993
1943	1969	1892	1935	1947	1970		1971		
1953	1976	1909	1937	1951	1981		1974		
1966	1978	1929	1943	1988	1987		1981		
1978	1982	1948	1949	1989	1994		1988		
1981	1994	1967	1957	1994			1990		
1984	1998	1972	1967	1995			1992		
1989		1980	1988	1998			1993		
1994		1985					1994		
1999		1986					1997		
		1987					1999		
		1989							
		1993							

Note. Tr stands for transplant.

This measure of the rate of change does not capture the contents of change so that it is not a direct measure of legal innovation, because legal change may re-enforce the status quo or even indicate regress rather than progress. For example, Colombia allowed companies to incorporate freely in 1853, but required state approval in the 1887 law.

Nevertheless, statutory legal change may be taken as a rough proxy of the responsiveness of statutory law to observed or perceived problems. The lack of statutory change may indicate that the original law works perfectly well and does not require adjustments. In an ideal world, laws should be fairly stable over time in order to ensure calculability of a legal system (Weber, 1981). Each legal change requires adjustment in corporate statutes or business strategies so that it imposes a cost. Furthermore, a stable law is a better platform for long-term planning. However, there is much need for legal change in the real world, because lawmakers can not foresee all future contingencies. Therefore, they must write incomplete law as Pistor and Xu (2003b) and Xu and Pistor (2002) assert. Once gaps in the law become apparent, lawmakers may want to fill them by writing new law or by reallocating lawmaking and law enforcement powers to agents who are capable of responding more flexibly to such changes.

Table 5 lists the rate of change in corporate law as measured by the average number of years between each major legal change from the first enactment of corporate statutes in a given country to 2000.

For the whole sample, corporate statutes are changed every 12.9 years on average. Table 6 presents the means for the various classifications of countries, namely, the major

Table 5
Rate of statutory change in corporate law

Countries	Ratio of change
Chile	14.6
Colombia	24.5
France	12.9
Germany	11.6
Israel	17.8
Japan	6.3
Malaysia	10.1
Spain	13.2
UK	8.7
US	9
Sample mean	12.9

Source. Compilation by authors.

Table 6
Comparison of means

Legal family	Common law	German and French civil law	
	11.4	12.61	
Source of law	Legal origins	Legal transplants	
	10.5	14.4	
Nature of corporate law	Highly enabling	Moderately enabling	Mandatory
	9	12.2	13.8

legal families, for origin versus transplant countries, and mandatory versus enabling corporate law.

As Table 6 indicates, there is little difference across legal families but substantial differences both between legal origin countries and legal transplant countries, and between highly enabling and less enabling or mandatory legal systems.

Comparing transplant and origin countries, origin countries change their corporate statutes every 10.5 years, on average, while transplants take over fifteen years to make these changes. Delaware, which has the most enabling corporate law, changes its corporate statute every 9 years on average. However, this calculation understates actual legal change in Delaware, because the law is changed on an incremental basis almost every year. We do not capture these smaller changes because we include only major change as defined above. Nonetheless, a series of smaller changes obviously necessitates fewer major ones. By comparison, the rate of change for the moderately enabling or mandatory legal systems is around 12 years, on average. Given the small sample size and the substantial variance across countries in different categories, generalization of these findings must be treated cautiously. Nonetheless, our evidence suggests that there are fewer differences in the innovative capacity for different legal families, i.e., common law versus civil law, than for transplant versus origin countries or for enabling versus mandatory legal systems.

A major challenge faced by enabling legal systems is the settlement of disputes over competing claims for control rights. For mandatory legal systems, this is less of a problem because the law itself clearly allocates control rights and does not leave much room for their reallocation. Therefore, it is sufficient to have courts enforce or reinforce the mandated allocation. In fact, many countries with mandatory corporate laws restrict judicial recourse in matters that are regarded as organizational disputes and should be resolved among the relevant stakeholders. By contrast, enabling corporate laws allow stakeholders to reallocate control rights, making the system more prone to open dispute. Moreover, enabling corporate legal systems also give directors and officers more flexibility in deciding major business strategies without direct involvement by shareholders. Although some authors argue that market forces are the best control mechanisms against abuse of these powers, e.g., Easterbrook and Fischel (1991) and Romano (1993), others are more skeptical and point to need of active law enforcement, e.g. Bebchuk (1989) and Coffee (1989). From the latter perspective, an enabling legal system is more dependent on effective enforcement institutions than are mandatory legal systems. In fact, as Professor Coffee has argued before, the increasingly more enabling corporate law of Delaware has increased the demands on the judiciary to determine the boundaries of the flexible statutory law. In fact, he considers the judge-made law on fiduciary duties to be corporate law's most mandatory core.

Courts are not the only enforcement institutions governing the corporate enterprise. Financial market regulators have emerged over time to address the failure of traditional law enforcement institutions. At first, these regulators emerged as self-regulators and, overtime, the stock exchanges gradually assumed regulatory functions over the companies wishing to list on their exchanges. The New York Stock Exchange established listing requirements for firms as early as the middle of the 19th century (Michie, 1987). The London Stock Exchange followed suit more slowly and somewhat reluctantly, but it eventually gave in to market and government pressures (Coffee, 2002 and Michie, 1999). Notably, these leading stock exchanges were established in countries that we characterize as highly enabling and moderately enabling, respectively. By contrast, France placed the *bourse* under state control after suffering a major market crash in the early 18th century (Hopt et al., 1997). Similarly, Germany responded to the founders' boom and crash in the late 19th century with strict regulation of the stock exchange, which virtually stifled market development (Merkt, 1997). In both countries, the regulatory approach mirrored that of the legislation governing corporations and mandatory state controls triumphed over experimentation. To be sure, mandatory rules became the hallmark of US-style securities regulation, which was enacted in 1933 and 1934 in response to the 1929 stock market crash. However, the emphases of US mandatory rules are on disclosure, which is less restrictive for experimentation and innovation than are mandatory rule that govern the substance of corporate affairs.

The evolution of enforcement institutions in transplant countries is more difficult to trace. The transplantation of legal systems typically entails copying both laws on court organization and procedural rules. In addition, transplant countries often copy securities regulations from their respective origin countries in the hope of jumpstarting financial market development. However, empirical evidence suggests that legal institutions in transplant countries are mainly less effective than are their equivalents in origin countries even after controlling for GDP (Berkowitz et al., 2003). Hence, transplant countries may have been less successful in institutional innovation designed to address problems of law enforcement.

4. Conclusion

Our evidence suggests that there are indeed substantial differences in the propensities of legal systems to innovate. We find the greatest divergence between origin and transplant countries, on the one hand, and highly enabling and all other systems, on the other. In contrast, we find little evidence that the civil versus common law divide provides strong explanations for differences in legal innovation. The last result is somewhat puzzling because common law countries tend to be more enabling than civil law countries. However, not all common law countries have used the potential advantage of the information that is revealed by the process of active litigation. Unfortunately, litigation data are difficult to collect so that testing the proposition that the rate of litigation is the main determinant of the rate of statutory legal change is infeasible. We also find that countries with more enabling corporate laws are the leaders in developing new types of lawmaking and law enforcement institutions, such as regulators. In fact, the future of these systems probably depends on the invention of such mechanisms to address the risks that are present in a more enabling approach to corporate law.

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