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Evolution of Corporate Law and the Transplant Effect: Lessons from Six Countries

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The pattern of legal change in countries that have their legal systems transplanted from abroad differs markedly from countries that develop their own systems, irrespective of the legal family from which their laws come. In "transplant" countries, law often stagnates for long periods of time; when change takes place, it tends to be radical, if not erratic. External models remain dominant even years after the law was transplanted. Although there is some evidence that transplant countries have engaged in comprehensive legal reforms in response to the pressures of globalization, it is still too early to judge whether these new changes can be taken as a sign that the legal systems in these countries have started a process of endogenous legal evolution.

The importance of law and legal institutions for economic development is widely acknowledged. The invention of credit mechanisms to support long-distance trade has been hailed as one of the preconditions for the development of capitalism in Europe (Milgrom and others 1990). The corporate form is regarded as a milestone for industrialization, the creation of viable market economies, and ultimately economic prosperity (Blumberg 1993; Hansmann and Kraakman 2000). For this reason, many former socialist countries quickly moved to enact new corporate codes or revive their prewar legislation (Pistor 2000).

Weaknesses in corporate governance, of which corporate law is a crucial element, has been blamed for the failure of major privatization efforts to enhance enterprise efficiency (Aoki and Kim 1995; Berglöf and von Thadden 1999; Frydman and others 1996). Improvement in corporate governance has become a major goal for economies in East and Southeast Asia hit by the 1997/98 financial crisis (Black and others 2001).

Empirical research based on a sample of 49 countries, most of them OECD member states, suggests that the level of shareholder protection is positively correlated with

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the development of stock markets, as measured by standard indicators, such as market capitalization and turnover ratio (La Porta and others 1997, 1998). Another empirical study (Johnson and others 2000) concludes that East Asian economies with more effective corporate laws were able to weather the 1997/98 financial crisis better than those in which shareholders were afforded fewer protections by the law on the books and the effectiveness of legal institutions, as measured by perception data.

A simple policy conclusion that could be drawn from these studies is that getting the "right" law on the books will boost financial market development. However, there are reasons to caution against such simplistic conclusions. The results of the studies on Asia could not be replicated in transition economies, where massive legal change, especially in corporate law, since the inception of economic reforms in the early 1990s has had remarkably little impact on the development of financial markets (Pistor and others 2000). Moreover, the causal relation between law on the books and economic outcome is not straightforward. As we show, countries with strong shareholder protection did not necessarily have better laws on the books when they developed their corporate law. They improved the law in response to challenges posed by the growth of the corporate and financial sectors. A key question then is, why do some countries develop better laws over time than do others? More generally, how does law evolve? Can we observe systematic differences in the evolution of law between different legal families (common law and civil law) on one hand and between countries that have their legal systems transplanted from other countries and countries that develop their own systems on the other?

We take a first step toward answering these questions by proposing that the process of legal change is crucial for the development of effective law. The intuition behind this proposition is that for law to be effective, it must become part of the institutional fabric of a society, contributing to the process of institutional innovation and change. Putting formal law on the books is not sufficient. Only when law is used—when it is modified in response to changing demands or socioeconomic conditions, such as changes in the size or ownership structure of firms or in the patterns of finance—will law be effective. In other words, the success of a legal system is not determined by having miraculously enacted good law at the outset but by developing the capacity to continuously find solutions to new problems.

Our analysis focuses on the development of corporate law in six "transplant" countries from the date they first imported the law. A transplant country is a country that imported its corporate law—typically wholesale with a set of other formal laws—from another country or other countries rather than developing it domestically. The six countries in our sample include three countries belonging to the French civil law family (Chile, Colombia, and Spain), two countries that took large parts of their formal legal system from English law (Israel and Malaysia), and one country (Japan) that imported German law in the late nineteenth century and U.S.-style corporate law after World War II.[1]

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Investigating the pattern of legal change over time requires a different set of analytical tools from those used to measure the level of legal protection at a given point in time. Empirical studies on the quality of corporate law have measured the level of shareholder and creditor rights protection by coding a set of predefined provisions. The assumption behind this approach is that the provisions that have been singled out as "good" law work irrespective of differences in local institutional conditions. However, local conditions may differ, and solutions found in one jurisdiction may be irrelevant for conditions found in others. If, for example, the major concern in a jurisdiction is that holders of large blocks of shares may expropriate minority shareholders, legal protection of minority shareholders that are directed primarily at management rather than blockholders may not be relevant.

To avoid these pitfalls, we take a broader approach. We do not limit the analysis to a set of predefined indicators. Instead, we explore the process of legal change in core areas of corporate law, including entry and exit of the firm, governance structure, and corporate finance, for each country. This approach allows us to track dead-end developments as well as identify where legal innovations first took place and then spread to other jurisdictions.

Who holds the right to initiate change is likely to influence the rate of legal change and the content of legal rules. When legislatures hold the exclusive right to initiate legal change, the rate of legal change will depend on the capacity of lawmakers to respond to the demand for legal innovation. In contrast, when a jurisdiction offers only "rules off the shelf" and allows stakeholders to opt out of them by reallocating control rights in the corporate charter or its by-laws, private actors will contribute to the diversity of corporate charters, and ultimately, corporate law. We therefore analyze not only the content of legal rules but also the allocation of control rights over key aspects of corporate law.

We use statutory law as a source for analyzing the timing and locus of legal change. This is admittedly a narrow approach, especially in common law countries, where case law is an important source of law. Still, even in these jurisdictions, the law on the books offers crucial information about legal change, and case law has often influenced the revision of statutory law.

We find notable differences in the pattern of legal evolution across the six transplant countries on the one hand and the four origin countries (France, Germany, England, and the United States) on the other (see Pistor and others forthcoming). In origin countries legal evolution tends to take place continuously and gradually, but legal change in transplant countries often stagnates for long periods. When change does take place, it tends to be radical, at times even erratic. We suggest that this pattern of legal change can be attributed to the "transplant effect"—the failure of an imported law to be accepted in a host country (Berkowitz and others forthcoming). As in medicine, transplants of laws can be rejected. A new statutory law may be ignored and thus fail to become an integral part of a country's socioeconomic infra-

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structure. Indicators of a lack of receptivity include legal stagnation or ossification even during periods of substantial socioeconomic change; a sequence of abrupt legal changes that can be explained only by repeated, but failed, attempts to solve a problem by importing foreign law; and a desire to follow other countries' legal development, even though there may be no domestic demand for legal changes. Differences in the process of legal change may at least partly explain the deficiencies in the effectiveness of legal institutions in transplant countries documented by Berkowitz and others (forthcoming).

Law and Economic Development

Social theorists, legal scholars, and historians agree that law has played a crucial role in the modernization and industrialization of the West over the past 200 years. The growing complexity of formal legal systems and the advance of constitutionalism and the rule of law during this period are perceived to have been key determinants of economic growth and prosperity. Max Weber went as far as stating that a calculable legal system was a precondition for the development of capitalism (Weber 1981).

The role of formal law can best be understood in a thought experiment in which formal law and legal institutions are assumed away and the state of nature is assumed to exist (Kronman 1985). Contracting and investments do take place in the state of nature. Kinship ties, reputation bonds enforced by relatively closely knit communities, and a host of self-enforcing mechanisms form the most important governance and enforcement mechanisms. Numerous historical and comparative studies (Ellickson 1991; Greif 1989; Redding 1990) have shown that these mechanisms can be remarkably effective. Yet they have important limitations. In a world with substantial transaction costs, informal governance mechanisms break down when the size of markets and the number of transaction become too large to render them effective (Charny 1990; Coase 1960). Put differently, the absence of formal legal protections of rights and interests limits the scope of economic activities to those that can be effectively governed by informal mechanisms (Bates 2001). Applied to the organization and operation of firms, this means that absent formal legal protections for key stakeholders, firms can grow and prosper only as long as transaction costs remain low enough that mutual monitoring and other informal enforcement mechanisms work effectively. If a firm seeks to expand its size or geographical scope or increase the number of owners, formal legal protection are needed.

Empirically, it has been difficult to conclusively establish the contribution of law and legal institutions to economic growth and development (Pistor and Wellons 1999). Case studies that track the development of law and legal institutions in particular countries or regions abound, but broader-based empirical studies employing statistical tools are rare, largely because reliable data are not available. Some

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advances have been made in recent years, however. Several studies have shown that perception data that measure effectiveness of legal institutions—the absence of corruption, the rule-based exercise and transfer of state power, the absence of expropriation and contract repudiation by the state, and the effectiveness of the judiciary—are positively correlated with the level of per capita GDP (Knack and Keefer 1994; Mauro 1995).

It has proved even more difficult to establish a clear empirical relation between the quality of particular rules or statutes and economic development. Even so, important progress has been made. In a study of 49 primarily OECD countries, La Porta and others (1997, 1998) show that the level of minority shareholder protection is significantly different across different legal families. Common law countries offer the best and French civil law countries the worst minority shareholder protection, with the German and Scandinavian legal families falling between the two. Common law countries also have less concentrated ownership and better developed financial markets than do civil law countries. An important implication of these results is that legal families are important determinants of financial market development (La Porta and others 1997). Implicit in this argument is that the causality runs from legal family to good law to good economic outcome.

If this proposition were true, policy advice would be straightforward. Though it may not be possible for a country to switch from a French civil law to an English common law system, it could certainly import key provisions from common law countries, such as Britain or the United States, in an attempt to boost financial market development. Unfortunately, this strategy has not been very successful in past law and development projects (Trubek and Galanter 1974). In transition economies the level of shareholder or creditor rights protection on the books does not have a statistically significant impact on the development of stock or credit markets (Pistor and others 2000). The effectiveness of legal institutions, in contrast, is a much better predictor of financial market development.

There is some empirical support for the claim that the process of lawmaking is more important than the content of legal rules. Analyzing the determinants of effective legal institutions using the perception data introduced by Knack and Keefer (1994), Berkowitz and others (forthcoming) show that legal families have little impact on the effectiveness of legal institutions. In contrast, there are remarkable and statistically significant differences between origin and transplant countries. Today origin countries have more effective legal institutions than do transplant countries that imported their laws.

Among legal transplant countries, some fair better than others. In particular, countries that adapted law in the process of importing it, as well as countries that had a population in place that was already familiar with the basic principles of the law being imported, have more effective legal institutions today than do countries that did not, even after controlling for GDP.

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These results suggest that legal transplantations, which for the most part took place more than 100 years ago, have cast a long shadow on legal institutions that can still be felt. Analyses of the legal development in transition economies have produced similar results. In these countries the effectiveness of legal institutions proved to be a strong predictor of financial market development. The relative effectiveness of legal institutions, in turn, appears to be determined by the history of legal development. Countries that had actively developed a formal legal system before they were incorporated into the socialist world have more effective legal institutions today than do countries that never developed such systems or contented themselves with retaining the rules imposed by foreign powers that had once ruled them (Pistor and others 2000).

This article builds on this research. It starts with the observation that transplant countries tend to have less effective legal institutions than origin countries, even when they emulate the contents of the law on the books. By exploring in greater detail the process of legal change in corporate law, we hope to explain why the transplantation of law has not solved the problem of legal backwardness.

Legal Evolution in Origin Countries

The four origin countries examined are the leading jurisdictions of the three major legal families (England, France, and Germany) and the United States (see Pistor and others forthcoming). The United States transplanted its law from England, but since the late eighteenth century its legal development has been sufficiently independent as to justify classifying it as an origin jurisdiction.[2] Individual states have jurisdiction over corporate law. We include Delaware, because it is the leading state for corporate law, as reflected in the fact that 62 percent of the firms listed on the New York Stock Exchange are incorporated there (Eisenberg 2000).

When the first corporate statutes were enacted, there were remarkably few differences across countries and legal families. Corporate statutes were short, and they focused primarily on the process of forming a company. They had little to say about internal governance structure, different classes of stock, or other aspects of corporate finance and even less about mergers and acquisitions and the rights of different stakeholders in such transactions. This lack of coverage may be attributable to the fact that at the time neither lawmakers nor private parties had much experience with the corporate enterprise; the need to find legal solutions for these issues arose only over time.

The four origin countries differ, however, in how they responded to the challenges of the rapid growth of the enterprise and financial sectors and to the booms and busts of financial markets that accompanied it. Most important are differences, particularly between the common law and the civil law families, in the allocation of control rights. In France and Germany the legislature exhibits a strong tendency to mandate a par-

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ticular allocation of control rights and to prevent stakeholders from reallocating them. In Germany a provision in the corporate law states that all provisions of the law are mandatory unless stated otherwise. A typical response in the two civil law countries to new problems was to tighten mandatory rules and restrict the ability of economic agents to determine the allocation of control rights. A good example is the 1848 Prussian law on corporations. The law reaffirmed the requirement of a state concession for establishing a corporation in response to the scandals that surrounded the railway mania in Britain (Kostal 1994). The Prussian legislature attributed the scandals to excessive leniency, which it sought to prevent by controlling entry to the market.

Similarly, in 1867 Germany finally allowed free entry subject only to requirements established by law. After it experienced its first boom and bust, however, the legislature intervened, tightly regulating the process of and the conditions for legal incorporation (Assmann 1992; Schubert and Hommelhoff 1985). Control mechanisms introduced in Germany at the time included the mandate to issue shares at a high legally established minimum par value, restrictions on the company's ability to repurchase stock, and a host of provisions that required shareholder approval, often with supermajority requirements for key decisions, including mergers and acquisitions and changes in corporate capital.

Only over the past decade have laws become more flexible in Germany and France. The general philosophy of corporate law in these countries remains that a mandatory law is needed to adequately protect key stakeholders of the corporation, including creditors and employees.

In contrast, control rights in England were and still are vested primarily with shareholders, subject to judicial review. Courts already played a key role in developing principles for company law long before the first Companies Act passed Parliament in 1844. They based their decisions on contractual arrangements and common law principles developed for partnerships and trusts (Davies 1997). Although statutory law became an important source of law after 1844, the law referred extensively to the articles of incorporation and thus to the allocation of control rights agreed on by shareholders. There are fewer mandatory provisions in the law than in Germany or France, but the law does not allow shareholders to reallocate control rights freely to corporate management.

Delaware shares with England the strong emphasis on shareholder control rights subject to review by the courts. It has been much more lenient in permitting the reallocation of control rights from shareholders to managers, however. In fact, the permissiveness of Delaware corporate law has been criticized by many as a race to the bottom in the competition for corporate charters (Arsht 1976; Cary 1974). One may argue that shareholders are free not to reallocate control rights, but shareholders tend to be passive investors, and directors and managers can easily influence shareholder decisions (Bebchuk 1989).

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The "enabling" nature of Delaware corporate law is reflected in many provisions of statutory law. Examples include the watering down of the ultra vires doctrine, which purported to limit the scope of business activity objectives stated in the corporate charter; legal provisions that allow directors rather than shareholders to change the corporate by-laws; the power of management to assess the value of in-kind contributions, which allows them to overstate contributions; the power of the board to determine the timing and pricing of authorized stock; and the relaxation of preemptive rights, which were designed to give existing shareholders a right of first refusal when new shares are issued. Many of these changes were introduced in the 1920s and finalized in the 1967 revision of the law.

Contrary to the expectations of many critiques, the relaxation of mandatory shareholder control rights has not undermined shareholder value. Empirical studies have concluded that reincorporating a company in Delaware does not decrease share value (Romano 1985). Moreover, companies incorporated in Delaware are doing as well if not better than firms incorporated in other states, controlling for size, industry, and other factors (Daines 2001).

An important explanation for the success of Delaware companies despite the state's relatively weak statutory legal protections is that courts have played a crucial role in upholding core shareholder rights under the broad principle of fiduciary duty (Coffee 1989; Fisch 2000). In addition, new control mechanisms emerged that placed limits on the scope of managerial powers. Most important, stock exchanges, and since 1933 the Federal Securities and Exchange Commission, have developed control mechanisms that have effectively limited the scope of discretion exercised by corporate management and compelled them to disclose key information not only to current shareholders but to the investing public. In other words, the relaxation of corporate controls did not create a legal vacuum. It did give corporate stakeholders greater flexibility and thus more room for experimentation. When this created greater possibilities for abuse, new mechanisms were established to counter them. This strategy has not avoided scandals (as is evidenced by the latest series of financial scandals in the United States), but it has proved remarkably resilient over time, which may be attributed to prompt reaction when scandals did materialize.

England and Delaware allowed greater room for experimentation and innovation than did Germany or France. In these two civil law countries the legislature has remained the primary motor of legal change. Once introduced, restrictions have remained on the books for decades. Perhaps these rules have spared the countries the financial distresses that have repeatedly rocked England and the United States, but the same restrictions have also limited the scope of legal change. The fact that financial markets in England and the United States are better developed than in France or Germany suggests that the strategy of allowing greater room for innovation has been more successful.

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Legal Transplants

All of the six transplant countries studied—Spain, Chile, Colombia, Israel, Malaysia, and Japan—took their corporate law from one of the four origin countries. Do the transplant and origin countries reveal different patterns of legal evolution? Recall that recent empirical studies have concluded that common law countries as a group outperform civil law countries in terms of the scope of minority shareholder protection they offer and the performance of their stock markets. Other studies, however, suggest that legal families have only limited predictive power with regard to the effectiveness of legal institutions and that differences between origin and transplant countries account for differences in legal effectiveness (Berkowitz and others forthcoming). A detailed analysis of the patterns of legal change in origin versus transplant countries allows us to test these competing propositions by examining the pattern of legal change in transplant countries. We start our analysis from the understanding that the strength of a legal system is not encapsulated in particular legal provisions found in statutory law but in the extent to which it promotes innovation and change without creating a control vacuum.

If legal families were the overriding factor determining the quality of corporate law and common law had certain features that allowed it to be more responsive than civil law, we should observe similar patterns of legal change in Israel and Malaysia as we did in England and the United States. If, however, transplant countries reveal different patterns of legal change, we should observe similar patterns of legal change in transplant countries irrespective of the legal system from which they adopted their law.

Our analysis reveals that with regard to the allocation of control rights in corporate law, transplant countries do indeed follow the basic philosophy of the countries from which they adopted their law. Israel and Malaysia have more flexible and enabling corporate law than the other countries in the sample (although they do not come close to the degree of flexibility that Delaware law affords). Spain, Chile, and Colombia have adopted a rather rigid approach to corporate law that exceeds that of the leading country in their legal family, France.

We find more systematic differences with regard to the process of legal change. In particular, we identify two distinct patterns of legal change: ossification and erratic change. In several transplant countries the law barely changed for decades, even though the country went through a period of rapid economic growth. This is particularly true in the two common law countries examined, Israel and Malaysia, but it is also true in Japan for much of the period under investigation. The development of corporate law all but stagnated during the period of high economic growth experienced since the 1960s by the "Asian miracle" countries and Israel.

Legislative activities have accelerated since the 1980s, most likely in response to growing economic problems and competitive pressures that resulted from the greater

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integration of financial markets. An open question is whether a different corporate law may have helped these countries prolong their growth period, if not prevent the subsequent stagnation or decline. Some commentators have indeed suggested that the Asian financial crisis of 1997/98 revealed weaknesses in the underlying institutional structure of the miracle countries (Black and others 2001; Johnson and others 2000; Pistor and Wellons 1999). As long as the economy was growing, these deficiencies were less apparent. Once growth slowed, however, institutions that could effectively buffer economic decline were lacking (Rodrik 2000). We propose that the weaknesses in the institutional infrastructure can be captured only partially by determining whether or not these countries had a particular set of legal rules on the books. The institutional weakness lies in the failure to adapt previously imported law to meet the demands of an economy that had changed markedly during the period of high economic growth.

The second pattern, erratic change, can be observed in Spain and Colombia. In Spain the 1829 corporate law started off as one of the most liberal corporate laws in Europe, only to be superceded by a highly restrictive version 20 years later. The change had a crippling effect on economic development and motivated the legislature in 1868 to turn the clock back to 1829. This suggests a certain level of responsiveness by lawmakers to the impact of earlier legal change, but one that preferred bold measures to fine-tuning.

Colombia also experienced erratic change that reflected the eclectic choice of models from which the law was imported. Colombia first followed the Spanish example, enacting a liberal corporate law in 1853. Unlike in Spain, this law did not have much impact, mostly because of the economic backwardness of the country, which rendered corporate law largely irrelevant (Means 1980). In 1887 the corporate law was revised, this time by adopting the Chilean model. The revised law led to a remarkable change in statutory law, as free incorporation was replaced with a mandate to obtain state approval. In marked contrast to the Spanish experience, however, the new law had no discernible effect on the Colombian economy. Still, it remains a puzzle why lawmakers turned the clock back without any apparent need. Means (1980) suggests that lawmakers were not aware of the change they were introducing. The country lacked a well-trained legal profession or lawmakers acquainted with corporate law developments elsewhere. Legal change occurred because lawmakers felt a need to follow one of the most advanced legal systems in Latin America of the time, not because there were particular domestic reasons for doing so.

The lesson we draw from this analysis is that countries that adopt foreign law are frequently unprepared for it or for the changes it brings. It is therefore not surprising that the new law does not become well incorporated into the institutional landscape or contributes to an ongoing process of institutional change. Our findings suggest that legal transplants cannot function in the host countries as they do in the home countries. Socioeconomic conditions, including overall economic development, the

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size of the corporate sector, the ownership structure of firms, and the patterns of firm finance, differ from country to country. Institutions that make a law work smoothly in one country, such as courts and regulators, may be absent, weak, or corrupt in another. As has been acknowledged, socioeconomic change takes place within the constraints of existing formal and informal institutions and thus is highly path dependent (North 1990). Even radical legal change will therefore not alter preexisting allocations of control rights overnight. This will take time and may not even succeed fully, as those fearing to lose from the reallocation of control rights are bound to change their behavior accordingly.

A Short History of Legal Transplants

Before examining more closely the development of statutory law and the core aspects of corporate law identified earlier (entry conditions, exit, reorganizations, corporate governance, and corporate finance), a short summary of legal development in the six transplant countries helps provide context.

French Civil Law Transplants

Spain already had substantial experience with French law during the reign of the Bourbons in the late eighteenth century. The law governing commercial activities, however, was based primarily on Spanish imperial law. It regulated entrance to the market but left customary trade to govern transactions among entrepreneurs (Coing 1976).

The Napoleonic Codes arrived in Spain with the French troops. The troops left in 1815, but the codes were kept on the books, subsequently replaced with national legislation that resembled the French law in many aspects but was not identical with it. The Spanish Código de Comercio of 1829 broke with a long tradition of special privileges, which granted far-reaching autonomy to merchants in Spain (Frey 1999). It legalized the relationship between the state and entrepreneurs as well as among them. Subsequent major revisions of the code took place in 1848 and again in 1868. Between 1885 and 1951 the code became more stable, although amendments were introduced from time to time. Since Spain joined the European Community, corporate law reforms have been targeted at complying with harmonization standards of council directives (Edwards 1999).

Chile was one of the first countries in Latin America to enact major codifications for civil and commercial law in the mid-nineteenth century. It borrowed from France as well as Spain, itself strongly influenced by French law. The 1854 law set the grounds for strong state control over commercial activities, which lasted in corporate law until 1981, when Chilean corporate law was overhauled. The new law borrowed heavily from the United States.

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Colombia enacted its first commercial code in 1853. The country was economically backward and had only a few incorporated companies, all of which had been authorized under Spanish imperial rule. Even after the enactment of the new code, few entrepreneurs were aware of the possibilities it offered, and most continued to operate as unlimited partnerships rather than seeking the protection of limited liability the law now offered. In 1887 the code was revised, apparently in an attempt to stay in tune with legal developments in neighboring countries, where major revisions of commercial laws took place in the 1880s. There were few domestic reasons for a major revision of the code. The model chosen this time was the Chilean law of 1854. There have been remarkably few changes in the corporate law since then, perhaps not surprisingly in a country that has been preoccupied with internal struggle and warfare.

English Common Law Transplants

After the dissolution of the Ottoman Empire following World War I, Britain established a protectorate over the territories that later became the State of Israel. The territories that today make up Malaysia were colonized by Britain in the late 1800s. The Federal Malay States were established in 1896, which led to the adoption of English law.

At least in some of its former colonies, the transmission of British law tended to be more gradual than the transplantation of statutory law from civil law countries. An important explanation is that unlike codified law, case law cannot be transplanted instantaneously. In most cases, a royal decree stipulated that English contract or company law as it existed at a particular date would henceforth be applied in the colonized territories. Where English judges sat in courts and applied common law to local cases, the evolving case law used English precedents. The different facts presented in the territories and recognition of local legal customs meant that case law increasingly diverged from the origin country (Hooker 1975). In this process, the law was adapted to local conditions. Consistency with English law was achieved by using the Privy Council in England as the Supreme Court for the colonial empire. Many countries continued to refer their cases to this court even after independence.

One might conclude that this gradual transmission facilitated the reception of the law. However, there is sufficient evidence to the contrary to caution against such a conclusion. Many experiments by British colonial lawmakers ran afoul because they ignored local conditions. A glaring example is the ultimately failed attempt to jump-start competitive credit markets in India by introducing a titling system and effective contract enforcement against defaulting debtors (Kranton and V 1999). Moreover, colonial rule often implied different standards for colonial subjects and colonizers, a fact that may have contributed to the alienation of imported law. The gradual transmission of law is thus only part of the story of transplanting English common law to former colonies. The British Empire sought to devise a shortcut by codifying law for

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the purpose of transplanting it to the colonies. India became the testing ground for this strategy (Pistor and Wellons 1999).

It was in this tradition that the English Companies Act was introduced in Israel in 1929 and Malaysia a few decades earlier. This transplantation was simplified by the fact that corporate law had been codified in England since 1844 and had been revised in England only in 1928/29. Both Israel and Malaysia changed their corporate laws only decades later. In Malaysia the corporate law was revised in 1965, this time using Australia rather than the former colonial power as a model. Because the Australian law was still very faithful to the English model, the law closely resembled the 1948 English law. It took Malaysia more than 20 years to catch up with the country from which it had taken its law. Little in the revised code suggests that domestic developments influenced the new law. Perhaps even more notably, the law hardly changed since 1965, despite the fact that Malaysia, together with other East Asian countries, went through one of the most expansive growth experiences in economic history during the next 20 years (Asian Development Bank 1997; World Bank 1993). Formal law was not irrelevant during this period, but administrative rules and regulations took precedence in Malaysia over general laws enacted by the legislature. This body of law performed an important function in the context of Malaysia's state-led development process since the introduction of the New Economic Policy in the early 1970s (Pistor and Wellons 1999). But it also undermined efforts to keep law that was designed for market- rather than state-based economic development strategies up to date.

Israel left the English law unchanged for an even longer period, from its first enactment in 1929 to 1983. In 1967 a package of securities market regulations was introduced, but the corporate law itself was revised only 15 years later. Another major revision of the corporate law occurred in 1999.

Transplants from Germany and the United States

Japan is an odd case in our sample because it transplanted law from two different sources. Germany served as a model for much of the new formal law enacted during the Meiji Restoration (Baum and Takahashi forthcoming). Japan received the second corporate law transplant from the United States in 1950 (West 2001). Before the imposition of U.S.-style law, Japan revised its corporate law only once, in 1937. Legal change accelerated since 1969 and was quite frequent in the 1990s, reflecting a greater awareness of the importance of law for the corporate sector.

Entry, Exit, and Reorganization

The major attributes of the corporation are shareholder limited liability, the existence of the corporation as an independent legal entity, and the free transferability of shares

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(Clark 1986). Corporate statutes typically define the conditions a corporation must meet to acquire these "privileges." In addition, the law tends to regulate who may make decisions about the dissolution (exit) or reorganization of a corporation.

In some respects transplant countries clearly benefited from the experience gained in origin countries, particularly with respect to entry conditions for corporations. At the time most of the transplant countries in our sample adopted their corporate laws, the origin countries allowed free incorporation and had enacted several safeguards to balance this change. Transplant countries copied these provisions and thus endured a much shorter period of trial and error.

The most notable exceptions are Spain and Chile. Spain introduced the system of free incorporation subject only to registration in 1829, 40 years before France did so, only to repeal this change shortly afterward. Although courts had substantial discretion in refusing registration, a special state concession was not required. In response to the liberalization of entry requirements, Spain experienced a major founders' boom, followed by a severe crash. The "backlash" (Roe 1998) occurred 19 years later, in 1848. The amended code demanded a royal decree as a condition for incorporation, stifling the market and adversely affecting economic development. In 1869—by which time the leading European powers, including France, had dropped the concession requirement—the pendulum swung back to free incorporation.

For the long-term development of corporate law in Spain, the revision of the Código de Comercio of 1885 was decisive. A major characteristic of this code was its emphasis on creditor rights. Merger transactions, for example, were made subject by law to creditor consent. Most of these provisions were retained in the 1951 overhaul of the code and still characterize corporate law in Spain.

For more than 100 years Chile established and maintained one of the most restrictive corporate laws. Two presidential decrees were required for a company's incorporation, one authorizing incorporation, the other verifying lawful incorporation and allowing the commencement of business. Once these decrees were issued, the company could be registered only for a fixed term, stipulated in the charter. State control also extended to mergers and liquidation. An amendment introduced in 1970 reallocated control rights over mergers to shareholders and required a supermajority vote. The principle of free incorporation was introduced only with the major revision of the code in 1981—more than 100 years later than the origin countries, France and Spain. The revision also shifted control rights over liquidation and mergers to shareholders.

Colombia introduced one of the most liberal incorporation regimes in the world in 1853. Lawmakers essentially followed the Spanish 1829 code, apparently without recognizing that Spain itself had moved back to a concession system in 1848 (Means 1980). In contrast to Spain in 1829, where the liberalization of entry requirements led to a founders' boom, the equally liberal Colombian law had little impact on economic development. The law of 1887 was almost identical to the Chilean model and

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included the rigid entry requirement of two presidential decrees, ignoring the fact that the Chilean model lagged far behind legal developments elsewhere in the world.

The Colombian case is an interesting example of a country that transplanted law for reasons that had little to do with domestic demand and had little expertise to assess the likely impact of the new law (Means 1980). The choice of legal models to be transplanted was determined primarily by the perceived prestige of the models. Internal socioeconomic developments or the fit of transplants with preexisting laws and institutions were ignored. There is little evidence that this approach to lawmaking has changed since.

The corporate statutes enacted in Israel and Malaysia in 1929 closely mirrored the timing of the transplantation. Free incorporation and shareholder control over major transactions as well as extensive disclosure requirements were the hallmarks of the English law at the time and were introduced without change in Israel and Malaysia. In Israel important changes affecting entry conditions were introduced in the first major revision of Israel's corporate law in 1983. Most important, the company registrar was given the power to refuse incorporation on public interest grounds. This change signaled a different role for corporate law within the context of a political system that frequently favored more extensive state control over economic activities than the origin country. In 1999 this provision was repealed. The registrar is now obliged to incorporate any company unless there is evidence of violations of the law, including violation of the procedural requirements for incorporation. As will be discussed, the 1999 revision of the corporate law marked a decisive change away from state supervision. Nevertheless, it continues to be much less enabling than the laws of Delaware. For this reason, Israeli entrepreneurs frequently incorporate their companies in Delaware, even when the firm operates in Israel (Rock 2001).

In Japan the switch from a German to a U.S. transplant had little impact on incorporation, as free incorporation subject only to registration had been recognized in the 1898 law, but merger rules were affected by the change. Under the 1898 law mergers required only public notice as well as a simple majority vote (by interest and number), whereas the new law established a two-thirds majority requirement, provided that half of the stock was represented at the meeting. This amendment strengthened control rights of minority shareholders to a greater extent than Delaware law does. Adoption of the stronger law can be explained by the fact that Illinois (rather than Delaware) served as the model for transplanting U.S. corporate law to Japan, and Illinois law of the time was much less permissive than Delaware law.

Corporate Governance

Where the state exercised control rights over entry and exit of corporations, it also ensured that it had some say over the governance of firms. This was the case in Spain

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between 1848 and 1868 (during the period when the government tried to regain control over the economy after the initial liberalization of 1829). During this period the government reserved the right to monitor the corporation and to call a special shareholder meeting at any time. Shareholders representing at least 10 percent of total stock were vested with this right only in 1947. Chile adopted the idea of continuous state monitoring in 1854 by including a provision that allowed the government to appoint a special inspector to supervise corporations. It retained this provision until well into the twentieth century.

Creditor control in matters of corporate governance was strong, particularly in Spain but increasingly in Chile as well. Already the Spanish code of 1829 stipulated that creditors could sue management for acting beyond the scope of powers explicitly vested with the corporation, thereby giving them some control rights over the scope of business activities. Chile introduced strong protections for bondholders in 1929 and strengthened their rights in 1931. In contrast, minority shareholders were given comparatively few control rights. Under the 1931 law shareholders representing at least 25 percent of common stock could demand an extraordinary shareholder meeting. In other jurisdictions the relevant threshold at the time was 10 percent, or as low as 5 percent in England and Germany. Chile adopted the threshold of 10 percent only in 1981. The threshold in Colombia is still 20 percent.

Spain, Chile, and Colombia closely followed the French model in terms of voting rights and the delineation of powers between the shareholder meeting and the board. Under French law it was possible to disenfranchise shareholders who held less than a minimum number of shares, as corporate charters could determine that only shareholders holding a specified minimum number of shares could exercise voting rights. The same applied to other countries belonging to the French civil law family.

In Israel and Malaysia the governance structure of the firm was and still is set forth primarily in the articles of incorporation (charter). Fundamental decisions, including changes in the charter, the by-laws, or corporate capital as well as decisions on mergers or liquidation have to be approved by special resolution requiring a three-quarters majority vote. The shareholder meeting appoints and dismisses the members. In Malaysia the board exercises the right to dismiss individual members at any time by ordinary resolution (simple majority vote). Israel's revised corporate law of 1983 retained the requirement of a special resolution (three-quarters majority vote) to accomplish this change, which was first introduced in 1929. In 1999 this provision was relaxed. A resolution passed by simple majority vote is now sufficient to dismiss members of the board. The 1999 amendment also introduced cumulative voting rights, which are, however, optional.

In Japan the American legal transplant established new requirements for firm governance. The 1950 law stipulated only that the board of directors manage the corporation. Relative to minority shareholders elsewhere in the world, minority shareholders in Japan had little control under the 1898 law. Major changes in the

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corporate charter, capital increases, and other changes could be adopted with only a simple majority vote, rather than the supermajority needed elsewhere. In 1950 the vote was changed to require a two-thirds vote by shareholders who are present at the meeting and who must hold more than 50 percent of outstanding shares. This requirement ensured greater participatory power by shareholders, in contrast to the law of Delaware, in which statutory shareholder protection, such as supermajority requirements, had already been relaxed. The 1950 law also extended the right to call an extraordinary shareholder meeting by lowering the threshold to only 3 percent.

Corporate Finance

The most extensive divergence across countries and legal families is found in corporate finance. One extreme, the German model, is characterized by legally mandated, detailed capital requirements, strong creditor protection, and limited discretion for corporate management. The other extreme, Delaware, allows extensive reallocation of control rights in favor of directors and management. The six transplant countries are closer to the German than to the Delaware model.

Spain, Chile, and Colombia all place substantial emphasis on protecting creditors. The law gives creditors veto rights over several decisions relating to corporate finance. Similar results may be obtained contractually be creditors in other legal systems. The fact that the law mandates a veto, however, denies any other allocation of control rights over changes in corporate capital. Creditor consent has also been required for decreasing corporate capital under Spanish law since 1885. France introduced this requirement only in 1930, marking an interesting example of reverse transplantation. Increases in corporate capital, however, were squarely put in the hands of shareholders. Since 1885 a simple majority has sufficed, although in 1989 a quorum requirement of 50 percent was introduced, most likely in response to European Union harmonization directives.

Chile

The 1854 Chilean law went far beyond the Spanish model in ensuring shareholder control over changes in corporate capital and introduced unanimous shareholder voting for changes in corporate capital. Only in 1970 was this rule relaxed for decisions concerning capital increases, which henceforth required "only" a 70 percent majority vote. The 1981 revision made changes in corporate capital much more flexible by requiring only a simple majority for increases or reductions in corporate capital. In contrast to Spain, where a quorum is required, only a simple majority vote by shareholders present at the shareholder meeting is needed.[3] Initially, the government determined the amount of corporate capital on a case-by-case basis. This followed

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directly from the fact that the state reserved the right to approve incorporation (Chile moved to a system of free incorporation only in 1981). Nevertheless, over time the law standardized some entry requirements for incorporation, thus limiting the discretion of state bureaucrats in charge of incorporation. In 1931 the minimum capital requirement for all corporation was set at 500,000 pesos. A decree issued in 1970, however, gave the government the right to deny incorporation if the capital was deemed insufficient for the business purpose contemplated. Both provisions were dropped in the 1981 revision of the law.

A reallocation of control rights away from the state and toward corporate stakeholders, in particular toward shareholders, can also be observed for minimum subscription and minimum paid-in capital. In 1981 the general rule was established that one-third of the capital be paid in at the time the company was incorporated; failure to do so lead to an automatic reduction of the corporate capital after three years. This rule was modified in 1997. Today capital must be paid in over a period of three years. Despite the general trend toward a more flexible law, some rigidity remains, including the provision introduced in 1981 that 30 percent of the company's profits must be paid out in dividends.[4]

Colombia

Within the French/Spanish legal family, Colombia has retained the most rigid corporate finance regime. The 1897 law prohibited any decrease in capital. In 1931 the state acquired new control rights by requiring state approval for any change in corporate capital. In addition, unanimous shareholder decision was required, a provision that was replaced only in 1971 by a 70 percent majority rule. Government control was extended to the evaluation of in-kind contributions in 1951. Share repurchases are restricted and require shareholder approval.

Malaysia

Malaysia's regime for corporate finance combines some rigid elements with some more flexible ones. Under the 1965 law, a simple majority vote sufficed for an increase in corporate capital. The concept of authorized stock did not exist. A 1987 amendment required shareholder approval for the issuance of shares and thus preempted the possibility that shareholders would authorize but the board would issue the shares. Shares are required to have par value, a requirement Delaware abandoned in the 1920s, but they may be issued at a discount or premium. There are also strings attached to decreases in corporate capital, which require a special resolution (approved by supermajority vote). Moreover, creditors can file a court case claiming that the reduction in corporate capital was inappropriate. Share repurchase was flatly prohibited under the 1965 law. This provision was revised in 1997, permitting share

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repurchase under certain conditions, including capital decrease, solvency of the company, or the possible cancellation of all rights attached to the shares.

Israel

Under the 1983 law, changes in corporate capital, including capital increases and capital decreases, required a three-quarters majority vote. Capital decreases had to be approved by the court, a provision that was repealed in England in 1867. Moreover, minority shareholders could appeal to the court to prevent a capital increase. Since 1999 a simple majority has sufficed for capital increases, and the board of directors has been able to decide on capital decreases unless the charter requires shareholder approval. However, creditors and shareholders may apply to the court and request to enjoin a decrease in corporate capital. Preemptive rights, which England did not know before 1980 and which Delaware made optional in 1967, were introduced only in 1999. The 1999 law did, however, allow the corporation to repurchase its own stock. Thus the law exhibits some inconsistency in the treatment of corporate capital, strengthening shareholder rights by including preemptive rights on the one hand and relaxing mandatory rules by allowing for share repurchase on the other.

Japan

The law governing corporate finance in Japan is a true hybrid of the two systems from which it derived its corporate law. The law has been surprisingly faithful to German law, with several restrictions based on the German model introduced only recently. An example is minimum capital requirements, which were introduced in 1990 and levied at ¥10 million. Neither the 1898 law nor German law at the time set minimum capital requirements. Like the German model law, the Japanese law specified the minimum par value, which was levied in 1898 at ¥20 and raised to ¥500 in 1950. Following the German model, in-kind contributions were allowed, but the amount and the number of shares issued in return had to be stated explicitly in the charter. The major amendment of the law before its replacement by the U.S.-style law, the amendment of 1938, restricted in-kind contributions. Only promoters were allowed to make in-kind contributions, and a court-appointed inspector had to ensure that they were assessed correctly. This provision was relaxed in 1990 to require an inspector only for contributions worth more than one-fifth of the capital or ¥5 million.

With respect to share repurchases, the Japanese law is as restrictive as the German law. In principle, share repurchase is prohibited. The 1938 law exempted only decreases in corporate capital and repurchases as part of merger transactions from this prohibition. The 1950 law lifted the prohibition on repurchases, at least in cases where the repurchase was used to compensate minority shareholders who exercised

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appraisal rights—an important complementary control device that Japan copied from the U.S. model.

The 1994 and 1998 Japanese amendments to the law governing corporate finance closely resemble recent changes in Germany and allow repurchases for employee compensation or stock option plans. Interestingly, preemptive rights were not included in the 1898 law, despite the fact that they were known in Germany at the time. The 1950 law made preemptive rights optional, this time following the trend in other U.S. jurisdictions that moved away from mandating preemptive rights in statutory corporate law. In 1955 directors were given discretion over specifying the rights of shares with each new issuance, placing preemptive rights squarely under the control of directors.

Summary and Conclusion

Legal systems have typically adopted the basic philosophy of the country from which they imported their law, with civil law countries tending to be less flexible and providing more protection to creditors than common law countries.

The pattern of legal change in transplant countries does indeed differ from that found in origin countries. Legal development in transplant countries often stagnates for long periods or changes erratically. A law may stagnate for many reasons. The law could represent a perfect set of rules that requires no change, although this is unlikely given that no lawmaker can possibly anticipate all future contingencies. Moreover, we find substantial legal change in the most advanced economies, suggesting that they are engaged in a continuous process of legal change. Another explanation is that stagnation may indicate the irrelevance of formal law. Informal governance mechanisms may work sufficiently well to render law irrelevant, or the state may direct economic activities through administrative rules and regulations, leaving too little room to private actors to make differences in corporate law relevant. Alternatively, law may stagnate because there is little demand in a country for a particular set of rules, as economic conditions are sufficiently different to render law unimportant. Whatever the reasons, legal stagnation signals rejection or only partial reception of legal transplants.

In addition to stagnation or ossification, we also observe more sporadic radical legal change in transplant countries. Typically, this type of change occurs in response to a crisis. Although crises are important motors for legal reform, crisis-driven legal reforms can mean that lawmakers overreact in a backlash fashion (Roe 1998). This is not a phenomenon limited to legal transplants, as evidenced by Germany in the late nineteenth century.

There are signs that the pattern of legal evolution has changed in many transplant countries over the past 20 years. Countries have begun to reform their codes more

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frequently. They have also relaxed some of the rigid control rights found in earlier laws and given corporate stakeholders greater flexibility. In some cases, this legal change was motivated by crises, as in Malaysia after 1997, and in Japan throughout the 1990s, or by radical changes in economic policies, as in the case of Chile's reform in 1981. But the greater frequency of legal change suggests that at least in the eyes of lawmakers, formal law has been elevated to an important governance device over the corporate sector. The demand for law by local actors may have increased as well. Future research should determine whether a more demand-driven process of legal change in response to domestic problems will result in more effective corporate law.

Apart from differences in the process of legal change, we also observe several differences in the allocation of control rights. Overall the patterns observed in origin countries—namely, that common law countries vest control rights primarily with shareholders and tend to be more flexible in allowing a reallocation of these rights—also hold for transplant countries. Nevertheless, no transplant country has come close to the flexibility of Delaware's corporate law.

The small size of the sample cautions us against overgeneralization. Our results do, however, suggest that legal transplantation is not an easy (and certainly not a short-term) solution for countries with less developed legal systems. For law to play a role in economic activities and long-term economic development, it must be incorporated, meaning that it must develop solutions to problems that exist in the home jurisdiction. As the example of the six transplant countries analyzed here suggests, it can take decades, if not longer, before transplanted laws are accepted.

The frequency of change in recent years and the greater selectiveness with which countries borrow from different legal systems rather than resigning themselves to the legal family from which they first transplanted their law suggests that the role of formal law as a governance device may be changing. Possible explanations include greater domestic demand as a result of economic change and development and increasing competitive pressures due to the integration of financial markets. Future research will have to analyze more closely the political economy of legal change. Greater emphasis should therefore be placed on the process of introducing new legal solutions and on how closely they fit preexisting conditions.

Notes

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1. Although a major objective was to ensure that each legal family was represented in the sample, the choice of countries from each legal family was determined primarily by the legal expertise of the authors and the accessibility of relevant legal material.

2. Testing for robustness by recoding the United States as a transplant country did not change the results (Berkowitz and others forthcoming).

3. Because the meeting can make a valid decision if 50.01 percent of shareholders are present, in effect this means that such decisions can be taken by 26 percent of outstanding votes.

4. According to La Porta and others (1998), this is a feature of the French legal system. In fact, it seems to be confined to several Latin American countries that followed the Chilean model.

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