The common law and finance

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The four papers that follow this introduction are lectures that were delivered in Oxford as part of a special series, *The common law and finance: perspectives from the bench*.[1] In the series, senior judges from four jurisdictions (Hong Kong, Australia, the UK and the US) were invited to reflect on the role of the common law judge in the regulation of commerce and finance. In this introduction, we explain the motivation for the series, provide a synopsis of the papers, highlight some common themes, and identify some areas that might usefully be the subject of further research.

The common law judge in the law and finance literature

It has now been a little over two decades since the publication of La Porta et al's seminal "Law and finance" paper,[2] in which the authors sought to compare measures of investor protection across countries and relate differences in levels of protection to the availability of finance.[3] The methodological step that made ~~exploration of~~ the latter question, a question of causation that would be expected to be fraught with endogeneity problems,[4] was the decision to classify countries in the sample by legal 'origin', or legal family. As the authors explained:[5]

"Even if we were to find that legal rules matter, it would be possible to argue that these rules endogenously adjust to economic reality, and hence the differences in rules and outcomes simply reflect the differences in some other, exogenous, conditions across countries … this is where our focus on the legal origin becomes crucial. Countries typically adopted their legal systems involuntarily (through conquest or colonisation). Even when they chose a system freely … the crucial consideration was language and the broad political stance of the law rather than the treatment of investor protections. The legal family can therefore be treated as exogenous to a country's structure of corporate ownership and finance. If we find that legal rules differ substantially across legal families and that financing and ownership patterns do as well, we have a strong case that legal families, as expressed in the legal rules, actually cause outcomes."

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2. R La Porta, F Lopez-de-Silanes, A Shleifer and Robert W Vishny, "Law and Finance" (1998) 106 J of Political Economy 1113.

3. This was done through a follow-on paper, "The Legal Determinants of External Finance" (1997) 52 J of Finance 1131.

4. See K Pistor, "Rethinking the 'Law and Finance' Paradigm" (2009) 6 BYU L Rev 1647, 1652; J Armour, S Deakin, V Mollica and M Siems, "Law and Financial Development: What We Are Learning from Time-Series Evidence" (2009) 6 BYU L Rev 1435, 1447–1449.

5. ~~(1998) 106 *Journal of Political Economy* 1113,~~ 1126.

Although the methodology used in these early papers attracted some serious criticisms,[6] the finding that levels of investor protection varied systematically by legal family and were strongest in common law systems has proved highly influential. The idea that law and legal tradition might "matter" for development was not, of course, new. As others have noted,[7] this question was explored by Hayek[8] and ~~later~~ by Weber, who puzzled over his "England Problem", namely the success of the English financial and industrial economy with a formally irrational common law legal system compared with codal France and Germany.[9] But nothing nearly so systematic as the work done by La Porta et al had been attempted before, and scholars flocked to the "legal origin" paradigm. A vast body of empirical literature exploring the "origin effect" emerged.[10]

These projects also prompted some more theoretical work on the channels through which origin might exert effects. One important line of thinking in this literature focused on the role of the courts, suggesting that the common law judge is uniquely well positioned to adapt legal rules to changes in market conditions.[11] Again, this idea was not a new one: claims about the adaptive capacity of the common law featured in foundational law and economics literature,[12] and inspired a number of projects seeking to model in formal terms how judge-made rules evolve.[13] Although clearly related,[14] this body of work has largely been unconnected with the "law and finance" literature on the adaptability of common law systems. Instead, that literature has often depended on highly stylised conceptions of the nature of common law and civil law adjudication, drawn from historical studies of the evolution of English and French courts.

The purpose of the lecture series was to elicit more granular evidence of the functioning of common law courts in a contemporary setting. A special benefit of the series was that this evidence would come from judges themselves: the lectures would offer an "internal view" by ~~commanding~~ judges of how they understood their

6. See eg in relation to the coding of measures of investor protection, H Spamann, "On the insignificance and/or endogeneity of La Porta et al's 'Anti-Director Rights Index'" (2006), working paper; in relation to the classification into legal families, MM Siems, "Legal Origins: Reconciling Law and Finance and Comparative Law" (2007) 52 *McGill Law Journal* 55 (and more recently, developing a different mode of classification, C Guerriero, "Endogenous Legal Traditions and Economic Outcomes" (2014) 44(2) *Journal of Comparative Economics* 416); and in relation to limits of cross-sectional data, Armour et al (*supra*, fn.4).

7. See eg KW Dam, *The Law-Growth Nexus*: *The Rule of Law and Economic Development* (Brookings Institution Press, 2006), 2–3.

8. See eg FA Hayek, *Law, Legislation and Liberty: A new statement of the liberal principles of justice and political economy* (1973), v,1, ch.4.

9. See DM Trubek, "Max Weber on Law and the Rise of Capitalism" [1972] Wisconsin L Rev 720.

10. See the review of the literature in R La Porta, F Lopez-de-Silanes and A Shleifer, "The Economic Consequences of Legal Origins" (2008) 46 *Journal of Economic Literature* 285.

11. See T Beck, A Demirguc-Kunt and R Levine, "Law and Finance: why does Legal Origin matter?" (2003) NBER Working Paper No. 9379, going on to explore this hypothesis empirically; ~~La Porta, Lopez-de-Silanes & Schleifer (2008) 46 *Journal of Economic Literature* 285,~~ 305, 310. A more subtle version of this idea was developed by Frank B Cross in "Identifying the Virtues of the Common Law" (2007) 15 *Supreme Court Economic Review* 21.

12. See e.g. RA Posner, *Economic Analysis of Law* (Little and Brown, New York, 1973), chs 23–24, esp. para.24.6; ~~Paul H~~ Rubin, "Why is the Common ~~law~~ Efficient?" (1977) 6 JLS 51.

13. See e.g. N Gennaioli and A Shleifer, "The evolution of the common law" (2007) 115 *Journal of Political Economy* 43; S Baker and C Mezzetti, "A Theory of Rational Jurisprudence" (2012) 120 *Journal of Political Economy* 513.

14. As acknowledged by ~~La Porta, Lopez-de-Silanes & Shleifer (2008) 46 *Journal of Economic Literature* 285,~~ 305.

own judicial cultures from within. Since law is a human science, the insights of those embedded in the process are of great value in understanding how the law works. We hoped that eliciting these judicial insights might help to put "flesh on the bones" of the adaptability thesis, and in this way invite the development of more sophisticated theories of common law adjudication, aspects of which might then be tested empirically. One does not need to subscribe to the "origins thesis" to see the value in such projects; indeed, such projects may well turn out to threaten the assumptions in the origins literature, or at least command their refinement.

Synopsis of the papers

The papers that follow traverse a wide range of subjects. Geoffrey Ma, the Chief Justice of Hong Kong,[15] analyses the operation of legal rules in Hong Kong commercial litigation, looking carefully at the interaction of precedent and statute across the history of the jurisdiction. He takes up topics such as control of money lending, company winding-up and resolution, and damages estimation, and explains the development of the law on a broad canvas. In his lecture, Justice Edelman, a Justice of the High Court of Australia,[16] broached the history of insolvency regulation, and provided a study of the evolution of laws seeking to balance the protection of creditors with the non-oppressive control of debtors and the protection of corporate value when insolvency strikes. His paper notes the role of legislatures in providing successive iterations of insolvency policy, with common law judges called upon to hone the application of broadly expressed rules and fill gaps. The rise of deeds of arrangement in Australian corporate law is used as a test case for these interactions of judicial and legislative policy with corporate market behaviours.

Lord Briggs, the presiding judge of the titanic Lehman insolvency cases in the United Kingdom and now a Justice of the United Kingdom Supreme Court,[17] offers a close study of how the common law courts can use and adapt core doctrines of common law and equity to resolve the most challenging battles over insolvency priorities following complex financial failures. Lord Briggs is sanguine about the ability of the courts to stretch conventional doctrine to afford pragmatic solutions, acknowledging that this may involve dealing with the instant crisis more than laying down durable rules to guide the future. He offers special insights into how creative adaptation of procedures including in relation to cross-border cooperation between courts helped deal with the most contagious and destructive failure in financial history. The fourth and final lecture, offered by Judge Easterbrook, a Judge (and formerly Chief Judge) of the United States Court of Appeals for the Seventh Circuit,[18] looks at ways to explain how the common law successfully regulates joint stock corporations and protects shareholder capital. He emphasises the sophistication of the courts in regulating fraud in representations of corporate prospects

15. Geoffrey Ma, "The Dependency of Business and Finance on the Common Law in Hong Kong: A Paradigm Jurisdiction" [2019] LMCLQ ??? (hereafter "Ma").

16. James Edelman, Henry Meehan and Gary Cheung, "The evolution of bankruptcy and insolvency laws and the case of the deed of company arrangement" [2019] LMCLQ ??? (hereafter "Edelman, Meehan & Cheung").

17. Lord Briggs, "The Lehman Insolvency and Beyond" [2019] LMCLQ ??? (hereafter "Briggs").

18. Frank H Easterbrook, "Legal Origins and Securities Fraud" [2019] LMCLQ ??? (hereafter "Easterbrook").

and performance, seeing this as a means to permit reciprocal disclosure of topical market information by all players, which deep and wide security trades can then disseminate as price information. He unpacks debates over judicial control of fraud of the market and insider dealing, and offers reasons to refocus the "origins" debate on the content of norms rather than their provenance in curial or legislative processes. Judge Easterbrook suggests that appellate judges in the United States context may be functioning as jurists with a self-consciously legislative and theoretical bent. This insight provides a fascinating counterpoint to the accounts offered by the other lecturers, which suggest a more incremental judicial style.

Common themes

Each of the papers provides a series of fascinating examples of the common law judge at work, making and refining rules for markets. There are a number of themes that are common to the reflections of the judges on ~~this~~ nature of this process.

First, a strong sensitivity to *ex ante* effects: the case decides the matter for the parties, but this decision sets the limits on the choices available to the universe of debtors and investors *ex ante*.[19] There may be good reasons to impose such limits, but they should be tailored to achieve their ends[20] and be clear enough for the parties to structure their affairs accordingly.[21] As Chief Justice Ma's paper makes clear, it is the giving of principled reasons by common law courts ("the reasoned judgment") that permits commercial actors to understand what has been decided and predict how that decision would likely be applied on novel facts.[22]

Secondly, in engaging in the process of common law reasoning, judges from common law jurisdictions draw on a common toolkit, in the form of precedent from English and other common law courts.[23] The presence of a corpus of cases stretching over centuries in a common language provides an opportunity for learning from the past. A line of reasoning introduced into one jurisdiction that has proved for some reason to be problematic can be dispensed with in another, providing a testing ground for the operation of the new rule that might inform the development of the law in the original jurisdiction. Conversely, courts may follow the approach already taken in other jurisdictions, shoring up the rule and establishing common ground that might facilitate, among other things, enhanced cooperation in cross-border cases. Such cooperation is a matter of considerable importance in cross-border insolvencies, as Lord Briggs' paper makes clear.

Thirdly, the papers suggest a relationship of mutual dependence between parliament and the courts. As Chief Justice Ma puts it, "the way many statutes are drafted presupposes a reliance, quite deliberate in my view, on courts to formulate and apply principles of law in order to solve at times very complex problems in a just manner".[24] The case of Hong Kong

19. See; Ma, ???; ~~Edelman, Meehan & Cheung, ???;~~ Briggs, ???; Easterbrook, ???
20. See eg the discussion of the use of assumption of responsibility in the assessment of damages for breach of contract in Ma, ???
21. See Briggs, ???
22. See Ma, ???
23. See Ma, ??? ~~and Edelman, Meehan & Cheung, ???~~.
24. See Ma, ???

money lending laws, which gave courts discretion to render enforceable a loan agreement or arrangement for security for a loan that would otherwise be unenforceable under the statute, is given as an example. As Chief Justice Ma explains, this made for a flexible regime, capable of adapting in response to the experience of the courts in the cases that came before it. Restructuring laws, dealt with in the first three of the papers that follow, provide a second example. Parliaments provided tools by which a majority of creditors could bind a minority to a compromise of their claims against the debtor, but largely left it to the courts to develop controls on the misuse of such procedures by one constituency to extract wealth from another.

Fourthly, there is recognition of the fact that judges, while sensitive to commercial realities, are not themselves business actors. Judges may limit by rule design the choices available to commercial actors, but they will not seek to exercise those choices themselves. Thus, in the Australian case study that is the subject of Justice Edelman's paper,[25] it was for the parties to determine whether a restructuring was desirable and what form it might optimally take, subject only to the (largely judge-made) rules designed to control for the risk of oppression.

Fifthly, there is an important suggestion that practice and procedure may matter as much as, if not more than, substantive law. This is a major contribution made by Lord Briggs' paper, which describes particular procedural innovations that enabled English courts to resolve important questions of law with considerable speed in the context of the Lehman insolvency. One was the establishment of a dedicated list for financial matters, entrusting cases to a select group of ~~specialised~~ judges with power to develop "bespoke case management" tools.[26] The tools developed included a power, in certain circumstances, to proceed by reference to assumed facts, dispensing with the need for full oral evidence to be heard before a decision could be made.[27]

Sixthly, there is recognition of the fact that common law judges do not always get it right. In his fascinating treatment of the contribution made by judge-made rules on fraud to the development of securities markets, Justice Easterbrook charts how developments in the case law at one point produced rules that would have appeared likely to discourage investment in the acquisition of information about a firm. This misstep was corrected in subsequent case law. Two observations made by Judge Easterbrook are particularly noteworthy: first, that the system was flexible enough to accommodate the correction;[28] secondly, that the mode of correction was a kind of "rehousing" or reclassification of the rules, so as to lay bare their contractual (facilitative) foundations.[29]

Future research

Many of the characteristics of common law adjudication identified above may ~~be~~ also be characteristic of adjudication in civil law courts (recognising the great diversity that exists

25. *Mighty River International Ltd v Hughes* [2018] HCA 38; 92 ALJR 822: see Edelman, Meehan & Cheung, ~~???~~.
26. See Briggs, ~~???~~.
27. See Briggs, ~~???~~.
28. See Easterbrook, ~~???~~.
29. See Easterbrook, ~~???~~.

within civil law traditions), and one line of future research could fruitfully interrogate this question. But there also seems to us to be significant scope for further research on the contemporary functioning of common law courts.

Four areas seem particularly promising candidates for further research. First, the contemporary operation of the network of common law courts, which might perhaps be usefully analysed using aspects of network theory. Secondly, the relation between parliaments and courts, a relationship that is not captured (perhaps because of its complexity) in models that seek to formalise the role of the common law judge by reference to judge-made rules alone. As others have noted, statute has long played a significant role in the regulation of the relationship between firms and their investors.[30] Thirdly, the role of practice and procedure. Rules of practice and procedure usually originate as judge-made rules, suggesting they should be at the heart of any attempt to understand how common law courts work. This area seems ripe for sustained empirical investigation.[31] Finally, and relatedly, there are important questions of judicial human capital to consider. These questions are taken up by Professor John Armour[32] in the comments that follow Judge Easterbrook's paper.

30. Dam (*supra*, fn.7), 37.

31. S Djankov, R La Porta, F Lopez-de-Silanes and A Shleifer, "Courts" (2003) 118 *Quarterly Journal of Economics* 118 is a pioneering example of such work.

32. J Armour, "Legal Origins and Securities Fraud—A Comment" [2019] LMCLQ ~~???~~.