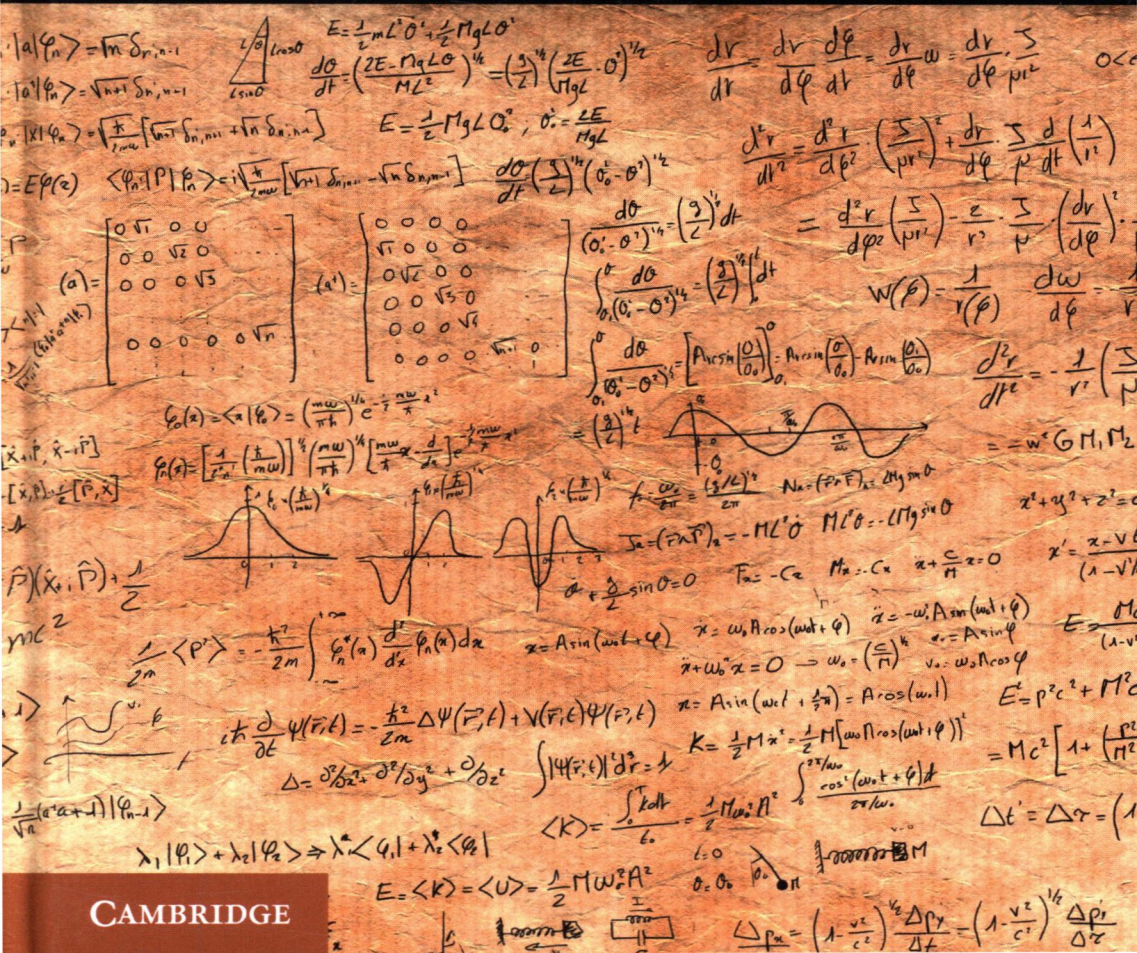
International Corporate Law and Financial Market Regulation

Economic Transplants

On Lawmaking for Corporations and Capital Markets

Katja Langenbucher



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Why and in what ways have lawyers been importing economic theories into a legal environment, and how has this shaped scholarly research, judicial and legislative work? Since the financial crisis, corporate or capital markets law has been the focus of attention by academia and media. Formal modelling has been used to describe how capital markets work and, later, been criticised for its abstract assumptions. Empirical legal studies and regulatory impact assessments offered different ways forward. This book presents a new approach to the risks and benefits of interdisciplinary policy work. The benefits economic theory brings for reliable and tested law making are contrasted with important challenges including the significant differences of research methodology, leading to misunderstandings and problems of efficient implementation of economic theory's findings into the legal world. Katja Langenbucher's innovative research scrutinises the potential of economic theory to European legislators faced with a lack of democratic accountability.

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Cover image: Old paper like parchment full of equations, graphs and matrix. (Credit: virtualphoto/Getty Images)

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For Johannes, Ben, Julius and Nick
with love

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International Corporate Law and Financial Market Regulation

Corporate law and financial market regulation have major implications for how the modern economy is organised and regulated and for how risk is managed and distributed – domestically, regionally and internationally. This Series seeks to inform and lead the vibrant scholarly and policy debate in this highly dynamic area by publishing cutting-edge, timely and critical examinations of the most pressing and important questions in the field.

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Introduction

The Plan of the Book and What It Does Not Cover

A medical student buying a book on 'organ transplants' probably has a good sense of what he is spending his money on. Similarly, a law student venturing to buy a book on 'legal transplants' will have little difficulty finding out what he is in for.[1] Legal transplants are known to imply 'displacement. For the lawyer's purposes, the transfer is one that occurs across jurisdictions: there is something in a given jurisdiction that is not native to it and that has been brought there from another.'[2]We are addressing a similar form of displacement. However, while legal transplants are transferred 'across jurisdictions',[3] economic transplants[4] are relocated across disciplines. Naturally, they are 'not native'[5] to the law because they originate in a different discipline. But what is being transferred? It cannot be 'the moving of a [legal] rule [. . .] from one country to another, or from one people to another'.[6]Instead, we will address a variety of concepts being transplanted from the economist's to the legal world. Think about a court relying on a prediction how capital markets will react to disclosure of inside information, based on input from the world of theoretical modelling of market processes. Imagine an empirical study presented to the legislator, benchmarking the strength of your country's shareholder rights against numerous other countries. Consider a neo-institutionalist contributing an article to a law review where he describes the incentives determining the conduct of a CEO

[1] Legrand (1997); (2003); Watson (1993); (1995); (1996). [2] Legrand (1997:111).
[3] *Ibid.*
[4] The term has, to my knowledge, only been used by Lianos (2009a); (2009b). He describes 'analytical concepts, such as market power, barriers to entry, consumer welfare, efficiency gains' in a competition law context, *ibid.* p. 56. He distinguishes this use from 'economic authority', *ibid.* p. 61. The term in the way it is used here encompasses both.
[5] Legrand (1997:111).
[6] Watson (1993:21); Legrand (1997:112) more finely elaborates on this quote.

when going about his daily work. Imagine this work is later referred to in recitals of a European Directive or in a judicial opinion.

It is tempting to start our endeavour with a clear-cut definition of economic transplants and proceed from there towards the different manners in which they make their way into the legal world. Despite its initial appeal, we shall not go down this path. In lieu of a definition, we will for now offer a few illustrations of economic theories, studies, claims and simplified versions of these and show where they could fit into a legal pattern of argument, reasoning and law making. Only towards the end of the first part, having discussed details of economic and of legal methodology will we be in a position to frame the concept of economic transplants more precisely.

One phenomenon we will address as 'economic transplant' results from empirical scholarship involving legal rules, court decisions or entire legal families like the common and the civil law. Scholars code such data to allow for quantitative analysis and for comparative scoring assessments and deliver policy advice on that basis.[7] The much-scolded assumption of rational, preference-maximising actors on capital markets is a second example illustrating how an economic transplant may enter the legal world. In a recital of the Market Abuse Regulation (MAR)[8] we read that 'reasonable investors base their investment decisions on information already available to them, that is to say on *ex ante* available information'.[9]The European Court of Justice took this understanding further, assuming that

'reasonable investors base their investment decisions on *all* ex ante available information'.[10]

The court in this way arrived at a combination of legal and economic concepts which, as we shall see in the third part of this book, did not yield a result necessarily in line with what economic theory would have suggested.

A more theoretical, third example is provided by neo-institutionalist scholarship on, for instance, rules on management remuneration.

[7] Djankov et al. (2008); (2007); Ferreira/Kershaw/Kirchmaier/Schuster (2013); La Porta et al. (1998); (2006); Lele/Siems (2007:43).

[8] Regulation (EU) No. 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/eC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC, OJ L 173/1, 12.6.2014.

[9] Recital (14) MAR.

[10] European Court of Justice, *Markus Geltl v. Daimler AG*, C-19/11, 28 June 2012 (Geltl), para. 55, italics added by me.

According to mainstream insights of agency theory, interests of owners and shareholders of a stock corporation are not necessarily aligned. While owners would like to see management make the value of their stock rise and pay out dividends, it can often be expected to primarily focus on rent extraction for its own sake. Dispersed shareholders will typically find it costly to monitor managers efficiently. Being rationally apathetic, they will not provide adequate control of good corporate governance, so the argument runs. Still following agency theory, a simple policy advice commended itself to yield promising results. Interests will be aligned if management is to be paid in stock options. Managers will focus on rising stock prices so as to make the most of their options. Owners will profit, too. When the former profitably cash in their options, the latter enjoy more valuable stock, to sell or to keep. Legislation facilitating the introduction of stock option plans often endorsed this very basic economic transplant.[11]

The natural legal audience for economic transplants like these are law-making institutions.[12] Large-scale studies appear to offer insights which seem tested and proven in a 'scientific' manner. Such insights find their way from academic debate into policy advice delivered by scholars, think-tanks or lobbyists.[13] Preparatory legislative material may pick up on such guidance. A recital in a European directive may refer to it. Later, lawyers working with legislation issued in this way may propose their interpretation of what an economic study or an economic theory could contribute to a case at hand. Judges will have to be convinced by the argument that a certain economic objective is embedded in a statute applicable to a case put before the court. Along these lines, economic transplants may appear as building blocks of a legal argument and find their way into the legal world.

Economic transplants of this kind seem to come naturally to both legal scholars and economists working in the broader area of corporations and capital markets. One discipline delivers data, models and predictions on how markets and corporations work. The other starts from such evidence and works out suggestions for drafting legal rules accordingly.

It will be submitted here that economics' methods are in the politico-legal universe often perceived as those of a 'hard' science, delivering tested and 'objective' insight. Under this assumption, economic transplants promise measurable law making. This appeals especially to the

[11] For critique see *pars pro toto* Bebchuk/Fried (2004); Bebchuk/Fried (2010); Bebchuk (2010); Bebchuk/Spamann (2010).

[12] Heise (2002:849). In more detail: Goldsmith/Vermeule (2002). [13] Riles (2011).

European legislator, who not only is faced with dividing lines between national jurisdictions but, in addition, has come under pressure on account of its weak democratic accountability.

However, we propose that things are usually more complicated. Despite both disciplines seemingly speaking the same language, the research methods they employ differ fundamentally in many respects.[14] This leads to a number of challenges which any economic transplant faces. The lawyer's hope to receive 'objective' evidence from economists will often not play out. Communication across disciplines may face cultural problems. Watered down versions of economic theory will surface in political legislative proceedings. Judicial interpretation may give economic transplants a very different face than their role in economic theory suggests.

The book is divided into three parts.

The first part is devoted to the question which promises economic transplants may carry for the legal universe in the European Union. We will arrive at these promises by taking a detour. We focus first on an economist's and a lawyer's epistemic background. We find that law and economics often seem to address the same phenomenon which makes cooperation natural and attractive. However, while their research methodology was once similar and economics understood as belonging to 'political economy', today's scholarship differs substantially. The interest in law making for corporations and capital markets will allow a focus on the economics of finance, and the impact on past legislation to concentrate on formal modelling and empirical work. We review economics' path from its more verbal tradition to today's increasing 'mathematisation'. From there, we discuss why some social sciences have felt under pressure from a perceived economic 'imperialism'.

The law's methodology escapes this straightforward form of presentation. We describe it here as comprising both work being done from a participatory point of view 'inside' a legal system and observations of such work from an external point of view. In the course of contrasting these points of view we will also be in a position to pin down the concept of economic transplants more neatly. These occupy the area where legal work done from an 'internal point of view' overlaps with work being done from an 'external point of view'.

[14] See for an earlier version of this argument Langenbucher (2015b:317).

The first part concludes by taking a closer look at three promises economic transplants hold in store for a European legal audience:

First, they appear to provide tested predictions on how capital markets work and how the people acting on those behave.

Second, they offer help to 'strip away complexity'[15] by delivering a clear question and a precise methodology to work with. What appears as an intricate political or legal question can be reframed as a problem of economic theory.

Third, they offer a common language for lawyers from many different national backgrounds. Our interest lies primarily with the European legislator. It is suggested that economic transplants can, on the one hand, function as a meta-language in which to converse. Reaching an understanding across legal cultures, different national statutory rules and legal principles in the European Union is not only challenging for comparative legal scholarship. It also poses enormous hurdles for both political dialogue and legislative drafting at the level of the European Union and, later, at the level of Member States transposing European law. Economic transplants may provide standardised tools for those tasks. On the other hand, the promise of a common language might prove appealing for a different reason. European lawmakers and regulators are increasingly confronted with their lack of democratic accountability. Law making is seen as insufficiently linked to a political consensus reached across Member States, even less as produced through a common legal heritage uniting those states. Economic transplants do not pretend to depend on any of those narratives. Instead, they use the language of scientific credibility. Law making, then, does not appear as a struggle about intricate legal and political issues. Rather, it comes across as the attempt to transport tested economic findings into the law.

The second part of this book explores these promises through the lens of a legislator. We present formal modelling as a basis for predictions of what statutory rules can hope to achieve. For a legislator, the focus, naturally, is on understanding how a model may be mapped onto real-world problems. Next, we look at empirical work as an attempt to measure and describe reality and in this way deliver input for the legislator. We show why empirical research is especially relevant for a legislator faced with passing rules for the 'real world'. Having

[15] The term stems from Lazear (2000:99), describing why economics' methodology has proven successful in taking hold in other social sciences. There is more on this context in Chapter 2.

established which promises economic transplants hold in store for the legislator, we revisit each of these promises in turn.

The promise of measurability is presented in the context of regulatory impact assessments. These have been in use by international organisations and legislators around the world in an attempt to size up and appraise the effects of legal rules. Quantifying and comparing legal rules forms part of this effort. Hence, we hope to learn more about how this could be done, and which challenges it entails.

The promise to strip away complexity has been invoked by scholars promoting a legislative 'culture of experimentation.'[16] Alluding to the natural sciences' method, this seems like an interesting path to put economic transplants to good use in the context of law making. We contrast the suggestion to strive for legislative experimentation with legal methods 'from the inside'. Concerns are raised about the extent to which a 'culture of experimentation' fits in with the web-like feature of the law. This leads us to a further question. Clearly, the law depends on abstract legal terms and concepts. Is this the lawyer's way of 'stripping away complexity', done from an internal point of view? If so, how is it similar and how is it different from abstract economic assumptions? It is submitted here that the use of abstract legal terms does, in a sense, effectively allow stripping away complexity. At the same time, it opens itself up to embrace the complexity of individual cases, a task largely entrusted to the judiciary.

The promise of a common language is reviewed in the context of European law-making bodies. We acknowledge its role as a potentially useful meta-language. However, there are a number of challenges. Moving economic transplants from a scholarly world of expertise into the arena of political debate entails the risk of such transplants morphing into economic clichés. Simplified and taken out of context, economic transplants risk losing much of what makes them commendable. A flip side of this challenge is their being perceived as belonging to an exclusive domain of expert talk, requiring intense training, hence being inaccessible to political dialogue. This carries the potential of further deepening a lack of democratic accountability. The more political dialogue incorporates issues commonly perceived as technical and open to expert assessment only, the more we see them delegated. Instead of opening such questions up to (often cumbersome and lengthy) parliamentary debate, they are placed in the hands of (bureaucratic) specialists. Their

[16] Greenstone (2009:113); Sunstein (2011:1364).