

Chapter 1

Interdisciplinary Issues in Comparing Common Law and Civil Law

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1.1 The “Comparative Quality” of Common Law and Civil Law as an Issue of Policy

For half a century after the end of the Second World War, agreement on the necessity of law as a framework for liberal democracy and the free market economy anywhere in the world was widespread in the Western value community (Schmiegelow 1997). After the end of the cold war, Western assistance to legal reforms in former East bloc countries was thus a natural political commitment both in Europe and America. Since the end of the 1990s however, a debate on the right choice between common law or civil law patterns appears to deprive such commitment of some of its a priori legitimacy.

1.1.1 *Law in the Philosophy of the Open Society and in Institutional Economics*

For the two leading thinkers of the twentieth century on the concept of an open society, Karl Popper and Friedrich von Hayek, law had to play a crucial role in the transformation of any society from absolutism, authoritarianism or totalitarianism to a liberal democracy and a free market economy. As a preface to the first Russian edition (1992) of his celebrated 1945 treatise *The Open Society and its Enemies*, Popper referred to the successful example of Japan’s joining the European civil law codification movement in the 1890s as a pattern for its legal framework for rapid modernization. He urged Russia to emulate the Japanese example by rapidly

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adopting a civil code. Hayek published his *Law, Legislation and Liberty* in 1973, at a time when development theory in the US seemed oblivious to law, and the lament of this was widespread among American legal scholars. In the 1990s, new institutional economics emerged with evidence that legally binding contracts (Coase 1988) and, more generally, a reliable legal framework for markets (North 1990) can reduce economic transaction costs.

1.1.2 Spontaneous Transformation Assistance After the End of the Cold War

Thus encouraged, the transformation assistance from Western donor countries developed as a spontaneous reaction to the fall of the Berlin Wall. Civil law countries such as France, Germany and Japan responded to demands from the transforming countries of the former Eastern Bloc for assistance in their legal reforms. They built upon their own part in the codification movement of the nineteenth century as well as on experience of assistance to legal reforms in developing countries after the Second World War. Most of the transforming countries did indeed adopt civil codes and commercial codes. While following basic patterns of the French, German or Japanese codes that seemed to have proven their functional quality by the test of time, they endeavored to adapt them to the cultural and economic context of their own societies. At the same time, common law countries have been proactively offering advice on legal reforms in many of the same transforming countries. The supply of US templates became particularly influential in the area of economic legislation.

There was no significant degree of coordination in these aid efforts. If there was competition between Western advisors on particular projects, it was not initially perceived as an institutional competition between common law and civil law systems, but rather between national bilateral aid programs, aid agencies, foundations, individual consulting firms or even just eminent legal scholars. Only about one decade later, did the issue of common law and civil law sources of advice working at cross-purposes emerge as a problem of policy choice.

1.1.3 The Recent Debate on the Comparative Quality of Common Law and Civil Law

To the surprise of aid agencies and legal communities of major civil law donor countries, the yearly “Doing Business” Reports of the World Bank (DB) began to imply sweeping challenges to civil law systems in the early 2000s and have continued to do so ever since (World Bank-IFC 2013). This sudden shift of opinion reflected the growing influence of a group of political scientists and economists

commonly referred to as LLSV (after the initials of the family names La Porta, Lopez-de-Silanes, Shleifer and Vishny) on the section of the World Bank staff in charge of the DB. Based on an unconventional combination of sociology of religion, legal history, political theory and econometrics, this group argued that protestant common law countries were better governed and offered superior business environments than civil law countries of French or German “legal origin”, with Latin American countries summarily counted as members of the group of countries of “French legal origin”, and China, Japan and the Republic of Korea as of “German legal origin” (La Porta et al. 1997, 1998). In the following decade, this argument was the subject of a large body of supporting and qualifying literature as well as of a major restatement by the first three of the initial four authors in the *Journal of Economic Literature* (La Porta et al. 2008). Since then it is usually referred to as “Legal Origins Theory” (LOT).

Institutional competition between common law and civil law is legitimate and desirable as long as it is open and unimpaired. Given the global institutional influence of the World Bank-IFC, its adoption of LOT elevates this approach from the status of an unconventional academic argument to that of a fundamental political challenge to civil law donor countries as well as to their efforts to assist transforming and developing countries. Transforming or developing countries initiating or continuing reforms of their legal systems will hesitate to follow advice inspired by civil law, since most of them depend either on financial support of the World Bank or on private investment attentive to World Bank opinion. They will be all the more hesitant as the reports of the World Bank are used as references in the country analyses of the major rating agencies and, hence, have a powerful impact on their international creditworthiness. Without a thorough examination of the methodology of LOT and the DB of the World Bank, institutional competition between common law and civil law appears impaired.

Reactions from civil law countries remained subdued, up to the present. The French Ministry of Justice did initiate a program on “attractivité économique du droit” headed by Bertrand du Marais, Conseiller d’État, which took issue with the poor scores metropolitan France obtained in the rankings of the World Bank’s DB and the country analyses of rating agencies (du Marais 2006; du Marais et al. 2007). It addressed the general methodological issue of measuring the economic impact of law and institutions (Ménard and du Marais 2006), but it did not raise the problems of imperial transplantation of foreign legal systems to unreceptive colonies or of assistance to today’s developing and transforming countries. Germany and Japan remained active in the area of transformation assistance. But there was no organized response to the fundamental challenge of LLSV and the World Bank. The *Zeitschrift für japanisches Recht/Journal of Japanese Law*, which is edited at the Max Planck Institut für ausländisches und internationales Privatrecht in Hamburg published an article on German and Japanese transformation assistance containing a short academic critique of the LLSV methodology (Schmiegelow 2006).

Significantly, more ample critical analyses of the LLSV approach appeared in common law countries. In a series of working papers, researchers at the Center for Business Research at the University of Cambridge argued that LLSV econometrics

contained biases masking dysfunctional conditions in US and UK corporate governance while amplifying negative aspects of the business environment in civil law countries (Ahlering and Deakin 2007; Armour et al. 2007). At the Brookings Institution, Kenneth Dam identified weaknesses of LLSV such as their mistaken treatment of Latin American countries as of “French legal origin”, insufficient attention to contract law, as well as econometric anomalies. Moreover, he raised the intriguing question of whether China’s extraordinary growth since espousing the market economy did not cast doubts on the nexus between law and development as assumed by Popper, Hayek, and new institutional economists as well as LLSV (Dam 2006). On the other hand, China’s extraordinary growth rates of the 1990s and 2000s cannot simply be projected into the future and the demand for law may become more pressing as the Chinese economy enters a development path of more balanced growth.

Finally, in a remarkable evaluation published in June 2008, the World Bank’s Independent Evaluation Group (IEG) recognized a number of methodological problems of the DB (World Bank-IEG 2008). More particularly, it questioned their exclusive focus on the cost of regulations for individual firms without consideration of their intended social benefits or development goals. It did notice that the base of informants (70 % representatives of globally active private law firms, only one or two of these for each indicator in each of the 178 countries) was far too small to warrant impartial results. It found fault in the lack of transparency of the way in which the World Bank-IFC DB staff processes the data obtained into country rankings, and arrives at changes in rankings over time. The IEG recommends different procedures for the selection of, and improved methodologies for research on new indicators before their global publication by the World Bank. However, it does not address the problem of the harm that may be caused by the continued publication of the ten indicators used with a deficient methodology by the DB. On the contrary, it commends World Bank-IFC for its assertive marketing of the DB. The problem of distortion of institutional competition between common law and civil law is therefore not resolved by the World Bank-IEG’s otherwise most useful evaluation.

In an implicit departure from the “legal origins approach” of LLSV, the World Bank-IEG (2008) conceded that a hypothetical civil law country combining the highest scores of the highest-scoring civil law country on each of the ten indicators would reach third place in the overall ranking. In her presentation at the workshop “Institutional Competition between Common Law and Civil Law” at the Université Catholique de Louvain on March 10, 2009 Victoria Elliott, the principal author of World Bank-IEG evaluation, took particular issue with the Employing Workers Indicator (EWI) of the DB, identifying inconsistencies between the EWI’s focus on the cost of employing workers and its claim to observe ILO standards (Elliott 2009). In a remarkable reversal, the World Bank Group published a note on April 27, 2009 stating that: “the EWI does not represent World Bank policy and should not be used as a basis for policy advice or in any country program documents that outline or evaluate the development strategy or assistance program for a recipient country”. The note expressed a commitment to remove the EWI from the World Bank

Group's Country Policy and Institutional Assessment (CPIA) record, review EWI, develop a new Worker Protection Indicator (WPI), and ask a new consultative group to offer broader ideas on labor-market issues to promote regulations designed to build robust jobs with adequate worker protection (World Bank IFC 2009).

These developments show that The World Bank Group, while maintaining the DB as one of its "flagship publications" (World Bank IFC 2009), is open to methodological critique. It is therefore worthwhile to extend such critique beyond the EWI, review all other nine indicators used in the reports in the light of the findings of World Bank IEG, develop new indicators helpful in orienting legal reforms, and replace the distorting method of simply averaging indicators for country rankings with indicators weighted according to their relevance for economic and legal policies. Basic assumptions of LLSV's political theory, religious sociology, economic model and econometric approach, which transcend the methodology of the DB, need to be thoroughly examined with the full cognitive resources of each discipline either boldly implicated, or summarily disregarded, by LOT.

1.2 Problems of Political Science, Sociology, Economics, Law and History

The academic communities of the countries concerned should provide the material for transparent institutional competition between common law and civil law. As LOT and the DB take an interdisciplinary approach, so must any debate taking issue with their conclusions or any policy at variance with their recommendations. As is the case for all discussions on economic development, the debate needs the involvement of political scientists, economists and sociologists as well as legal scholars.

If "legal origins" are supposed to influence development, particular attention must be paid to political theory, international relations theory, institutional economics, the theory of economic development, econometrics, comparative law, the sociology of law, legal history and, more particularly, the history of failed and successful legal transplants. This is suggested by the different methodological problems of the LOT and World Bank approaches on which critical analyses published so far have focused, and more particularly on:

1. the inability of static cross country analysis such as LOT's to capture the economic effect of legal changes over time (Schmiegelow 2006; Armour et al. 2007, Chaps. 2, 3, 5, 15, and 18)
2. the heavy price LOT must inevitably pay in terms of thoroughness of legal analysis to obtain the econometric robustness derived from its samples of over 100 countries (Boucekkine et al. 2010; Schmiegelow 2013; Kawai and Schmiegelow 2013, Chaps. 3, 5, 15, and 18)

3. the lack of detailed legal analysis of shareholder protection rules of substantive corporate law in countries central to LOT's assertion of common law superiority for financial markets (Cools 2005; Braendle 2005)
4. LOT's and DB's method of measuring comparative efficiencies of common law and civil law judiciaries exclusively based on data of the duration of court procedures obtained from international networks of law firms, which masks the basic cost and time inefficiency of lawyer-dominated common law procedure lamented by the most authoritative American scholars of comparative civil procedure (Kaplan et al. 1958; Langbein 1985) and eminent authors of proposals for reform of English civil procedure (Lord Woolf 1996; Lord Jackson 2009, Chap. 5)
5. LOT's association of common law procedure with the postulated ideal of litigants having their dispute settled by their common neighbor (Djankov et al. 2002) is seriously undermined by the abolition of the civil jury trial in England and Wales in 1933 (UK Administration of Justice (miscellaneous provisions) Act 1933) and by its "vanishing" (Galanter 2004, p. 459) over the past 100 years in favor of lawyer-brokered settlements and other alternative modes of dispute resolution in the US (Schmiegelow 2013, Chap. 5)
6. a major inconsistency between the superiority, recognized by LLSV (La Porta et al. 1999, 2008), of average long-term economic performance of countries coded by LOT as of "German legal origin" since the 1960s as compared to common law countries and the "political theory" (La Porta et al. 1999), nonetheless maintained by its authors, that the quality of government of common law countries is superior (Schmiegelow 2006, Chaps. 3 and 5)
7. significant misunderstandings of the history of Roman law, such as its overriding concern for the protection of private property (Zimmermann 1996; Robaye 1997), of common law, such as its debts to Roman law (Hayek 1973), and of civil law, such as the economic liberalism of the French, German and Japanese civil codes (Zimmermann 1996; Schmiegelow 2006; Ahlring and Deakin 2007, Chaps. 3, 5, and 18)
8. a sociology of religion based on Robert Putnam's thesis that protestants have more trust in strangers than Catholics (Putnam 1993), but as obviously refutable as Max Weber's protestant explanation of capitalism by the histories of mediaeval bankers like the Medici, Fuggers and Welsers as well as contemporary Japanese and Chinese capitalism (Schmiegelow and Schmiegelow 1989). While trust of investors in the management of corporations may be a condition of their decision to buy shares of that corporation and hence play a functional role in economic performance (Roe 2006), the theory of bubbles and financial crises shows how dysfunctional such trust may become, if it is based on irrational expectations (Shiller 2000), or, as in the subprime crisis, expectations considered rational by flawed models of financial engineering (Schmiegelow and Schmiegelow 2009, Chaps. 4, 5, and 15)
9. the insufficient attention to the institutional economics of contract law, balancing the synallagmatic interests of contracting parties such as producers

- and consumers, owners and tenants, employers and workers, creditors and debtors (Dam 2006; Schmiegelow 2006, Chaps. 3 and 6)
10. weaknesses in comparative law such as the coding of Latin American legal systems as being of “French legal origin” (Dam 2006, Chap. 8)
 11. failure to consider that international relations theory requires a distinction be made between colonial transplants of law as in most developing countries of the former British and French empires and the voluntary participation of independent countries such as Switzerland, Japan and Thailand in the European codification movement of the late nineteenth and early twentieth century (Berkowitz et al. 2003; Schmiegelow 2006, Chaps. 2, 3, 5, 7, 8, 9, 10, and 15)
 12. the risk involved in large samples of countries with overwhelming majorities of former colonies of unwittingly measuring the negative “transplant effect” (Berkowitz et al. 2003) of imperial imposition of foreign legal systems to unreceptive countries rather than the intrinsic qualities of English common law or French civil law (Schmiegelow 2013, Chaps. 5, 7, 8, 9, 10, and 15).

1.3 The Importance of Refocusing on the Primary Sources of Institutional Economics

To refocus the debate on the benefits of legal reforms in industrialized, emerging, transforming and developing countries alike, a return to the original focus of institutional economics appears necessary, i.e. the transaction cost reducing role of reliable contracts and regulatory frameworks for free markets balancing the interests of producers and consumers, owners and tenants, creditors and debtors, employers and employees, shareholders, stakeholders and management of corporations. Common law and civil law traditions—whatever their differences in style and jurisprudence—share a commitment to the rule of law as a universal good. Both have been adapted in countless ways to the cultures and economic conditions of individual societies including those of their countries of origin. The demand for law in the “mother countries of legal origins” as well as in today’s emerging, transforming and developing countries implies the expectation of such adaptability. Provided they are responsive to that expectation, both common law and civil law traditions can serve as reservoirs of functional solutions for legal reforms in any type of country and in interaction with any cultural context.

1.3.1 *The Need for a Reassessment of the Functional Qualities of Modern Civil Law Systems*

While comparative lawyers have used functional analysis as a method of comparative law for a long time (Dannemann 2006), few of them would be inclined to take the dazzling use of econometric regressions of a conspicuously limited selection of

indicators as a measure of the functional quality of common law or civil law seriously. Yet, there is growing awareness that the challenge of LLSV and the World Bank-IFC needs to be met in the arena which they have chosen, i.e. a very basic sociological functionalism, quantified by indicators easily measured by econometric regressions and controlled by the logarithm of per capita GDP of the countries compared.

The German and the Japanese civil codes and civil procedure codes offer particularly interesting material for comparative functional analysis as they have stood the test of time in more severe conditions than most transforming countries today. They provided an immediately available institutional framework for the economic revival of two countries more completely destroyed in the Second World War than any other country in any previous war (Schmiegelow and Schmiegelow 1989; Schmiegelow 2006). *Prima facie*, they appear better suited to help “jump start” economic development in transforming and developing countries than a strategy of waiting for a slow process of judge-made law emulating the history of common law. The economic histories of divided countries such as postwar China, Germany, the Republic of Korea or India and Burma/Myanmar as successors of British India can serve as quasi “natural experiments” permitting the measurement of the causal effect of institutions on economic development in a much more reliable way than LOT’s static cross country analyses (Acemoglu et al. 2005; Boucekine et al. 2010; Docquier 2012, Chaps. 2, 3, and 5).

It is especially rewarding to compare the functional quality and minimal transaction cost of the default rules offered by contract law in civil codes to all citizens who do not wish, or cannot afford, the legal advice necessary to draw up specific provisions from voluminous compendia of precedents needing to be referred to in order, at great cost, to make contracts safe against the risk of disputes before common law courts (Boucekine et al. 2010, Chap. 3). In this context, it is significant that US scholars of contract theory have recently begun to focus on the merits of relying on such default rules as a legislative technique in the US as well (Barnett 1992).

The subprime crisis suggests the salience of mandatory general clauses in the negotiating phase of concluding contracts. Civil codes contain general clauses on “good faith” denying enforceability of contracts based on severe information asymmetries, if enforcement would breach the trust of the uninformed party (Farnsworth 1987; Nedzel 1997). Common law judges have traditionally refused to accept such limits on the behavior of contracting parties (Farnsworth 2006). Unwarranted trust of homebuyers in mortgage brokers ready to overextend credit to clearly overburdened borrowers is now recognized in both common law and civil law countries as one of the main causes of the crisis. This is also the case of unwarranted trust of investors in the AAA rating of securities collateralized by such mortgages (Schmiegelow and Schmiegelow 2009). Robert Shiller of Yale University has suggested that the institution of a civil law notary in the US might have helped mitigate the information asymmetry between homebuyers and mortgage brokers (Shiller 2008). The two editors of this book argue that general clauses of the civil law type and their effective enforcement might have prevented massive

foreclosures for homeowners and hence enormous transaction cost as well as macro-economic cost (Schmiegelow and Schmiegelow 2009, Chap. 4).

Inversely, under the impact of the consumer protection movement in the US, the private autonomy of contracting parties in the civil codes of France and Germany was significantly reduced by EU legislation requiring member-states to revise their civil codes so as to condition the validity of sales contracts in complex procedures increasing the transaction costs of both producers and consumers (Boucart 2005; Riesenhuber 2007).

High degrees of creditor protection and of contract enforcement in Germany and Japan are already attested by LLSV themselves, one of the inconsistencies calling into question the broad sweep of their conclusions. Creditor protection in German and Japanese corporate law even turned out to be a step too far for the public good. It ended up by being criticized as an impediment to the setting up of new businesses and was, or is being, lowered in both countries (Bundesministerium der Justiz 2009; Baum 2001).

Property rights and debt enforceability is one of the major concerns of both LOT and DB. The “Registering Property Index” (RPI) is one of seven of the ten indicators of ease of doing business where the top ranking countries are those with the *prima facie* fewest requirements and lowest costs. But comparative economic studies of two major property conveyancing and titling systems have revealed that apparently simple recording systems such as the American and French ones, where it is sufficient to deposit the agreement to acquire a real estate property at the County recording office, in the end is a much more costly and much less safe method of property conveyance than a public registry such as in Australia, Denmark, Germany and Spain, when the ownership of the seller comes to be questioned. For, while recording offices must accept all signed documents whatever their legality and their collision with preexisting rights, public registration of a new right requires a purge of all older preexisting contradictory rights (Arrunada and Garoupa 2005; Arrunada 2011, 2012a, b). In most civil law countries with a public registry system, the notary authenticating the property sale or mortgage is bound by law to examine the legality of the contract and the absence of contradictory rights before conveying it to the registry. In the American recording system, title examiners are needed to examine all deeds dealing with the concerned parcel of land in the past and to certify the legality of the document in question. This is lucrative for title examiners, but the risk of legal uncertainty remains with their clients. In the subprime crisis, millions of mortgages packaged in asset-backed securities required title searches as subprime borrowers became unable to service their debt. Hernando de Soto, the Peruvian scholar of the deficiencies of property law in developing countries, has compared the US recording system to dysfunctional conditions in Latin America (De Soto 2009). It turned out to be a major structural impediment to rapid crisis resolution (Chap. 4). Evidently the RPI needs to refocus on the comparative advantage of public recording systems for any country like the US determined to rely on financial innovation for economic growth. Only a public recording system makes securitization of mortgages and trade in such securities possible, as any lender, any investor and any holder of mortgages and similar property assets

can check the identity and contents of the asset involved in the public registry at any time (Schmiegelow and Schmiegelow 2009). Significantly China's new property law has opted for a public registry system (Rehm and Hinrich 2009).

Shareholder protection against corporate insiders was initially another of the major areas where LLSV assumed common law countries to be superior to civil law countries. Prompted by studies detailing Belgian, French and German shareholder rights functionally equivalent to common law anti-director rights (Cools 2005; Braendle 2005), LLSV replaced the anti-director rights standard by indicators such as securities laws governing new rights issues and corporate laws preventing self-dealing transactions by insiders (La Porta et al. 2008).

Both the US and the UK recognized the need of reforming their take-over rules in the 1960s. Since very different interest groups reflecting the different economic structures of the two countries at the time (still preponderantly industrial in the US, predominantly financial in the UK) supported the reform in the two cases, the results are very different, enabling shareholders to delay and impede a takeover in the US, while ruling out any attempt to frustrate it in the UK (Baum 2009). In various combinations, France, Germany and Japan have adopted elements of one or the other, or both. There is no longer any common law/civil law divide (Armour et al. 2007). Moreover, control by the logarithm of per capita GDP does not confirm superior quality of either the US or the UK solutions as compared to the corporate law regimes of civil law countries as a group. In its latest restatement, LOT admits that Germany's and Japan's average economic performance exceeded that of the US and UK since the 1960s, i.e. since the corporate law reforms in the US and UK (La Porta et al. 2008).

Germany's and Japan's superior average long-term economic performance must be all the more intriguing from LOT's point of view, since the financial sector of these two countries has been marked by indirect financing of corporate investment through banks rather than the direct financing from the capital market (Schmiegelow and Schmiegelow 1989). Indirect finance has been regarded as backward by generations of economists following in that respect Alexander Gerschenkron's theory of backwardness (Gerschenkron 1962) and it is not surprising that LOT took the capital market model prevalent in the US and the UK as an axiomatic standard. More recent analysis of financial intermediation takes a more balanced view, however, finding virtue in the banks' traditional role of reducing information asymmetries between providers and receivers of capital. They should (ideally) also be safer in absorbing inter-temporal risk for household savings and in monitoring management performance in "relationship banking" with small and medium enterprises (Schmidt et al. 1998). "Old-style" financial intermediation by commercial banks may have been more functional than the "innovative" securitization driven by US investment banks after all (Rajan 2005).

Whatever the judgment of history of these different financial systems may be in the end, however, they can no longer be linked to "legal origin". France has made great strides in the process of disintermediation recommended by the IMF and the World Bank as a global standard. Securitization both on the asset and the liability side of French non-financial sectors indicates that France has been changing from a

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