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Law and Economics Approaches to Corporate Governance

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Abstract

This paper provides a critical assessment of existing theoretical approaches to corporate governance within law and economics. Conventional economic approaches to law, new institutionalism and behavioural science, as well as the transplant literature, are discussed and their limits indicated. We suggest that by incorporating novel concepts, such as receptiveness, familiarity, adaptation, and internal process of development, the evolutionary dynamics of law and economics signifies a tendency towards corporate governance analysis that involves the study of institutional change and deals with questions that cannot be easily quantified. Such perspective invites a further look into the nature and evolution of legal norms and opens a way for a review of corporate governance arrangements from the perspective of unconventional socio-legal theories.

Keywords: • Corporate Governance • Law and Economics • New Institutionalism • Legal Transplants

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Pravni in ekonomski vidiki upravljanja družb

NINA K. CANKAR, SIMON DEAKIN AND MARKO SIMONETI

Povzetek

Prispevek kritično ovrednoti obstoječe teoretične pristope ekonomske analize prava na področju upravljanja družb, s poudarkom na klasični ekonomski analizi prava, teoriji t. i. novega institucionalizma in literaturi s področja transplantacije pravnih norm ter z namenom opredeliti in nakazati njihove meje. Moderni pristopi, ki so v analizo pravnih pravil vpeljali nekatere nove koncepte, kot so dovzetnost, prilagodljivost in notranji proces razvoja, nakazujejo trend v smeri obravnavanja področja upravljanja družb s pomočjo elementov, ki se jih težje meri in kvantificira. Takšen pristop zahteva podrobno obravnavo narave in razvoja pravnih norm ter s tem odpira pot analizi korporacijskega upravljanja z vidika manj znanih teorij prava in sociologije.

Ključne besede: • upravljanje družb • ekonomska analiza prava • novi institucionalizem • transplantacija pravnih pravil

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1. Introduction

"The proper governance of companies will become as crucial to the world economy as the proper governing of countries" (Singh, 2003: 43). This statement underlines a vigorous debate that has emerged in the last decade on the merits of corporate governance arrangements[1] around the world, and in particular, regarding their relation to the development of capital markets.

As Jordan and Lubrano (2002: 2) put it: "It has become a truism that the pressures of the capital markets will improve the governance of corporations; equally, that improvements in corporate governance will promote development of the capital markets". Weak corporate governance performance has generally been regarded as an important factor responsible for the weakening confidence in capital markets.[2] As a result, countries worldwide have resorted to various mechanisms and a number of propositions have been advanced with respect to the improvement of corporate governance practices.

The conventional way to approach corporate governance issues has been the interdisciplinary "law and economics", which has, since the 1960s, been offering a productive ground for studying the link between legal change and economic development. The law and economics approaches to corporate governance were triggered by the pioneering work of Ronald Coase in the 1960s. In essence, these approaches are based on agency theory and game-theoretic analysis. They regard law as an institution that shapes and constrains human behaviour and perceive law and economy as being inextricably linked and mutually constitutive. From this perspective, law directly influences and shapes economic decisions through its formal set of rules.

Recent crisis and the collapse of capital markets worldwide call for a reassessment of the generally accepted assumptions on the evolution and characteristics of corporate governance systems. It has been observed that corporate governance reform did not work as intended; in general, it did not

[1] Corporate governance can be defined generally as a system by which companies are directed and controlled (Cadbury Report 1992 - Report of the Committee on the Financial Aspects of Corporate Governance, available at http://www.ecgi.org). This is the most commonly accepted definition of corporate governance, which can be defined in many ways. Perhaps the most noticeable is a distinction between a narrowly defined notion of corporate governance (so as to encompass the conventional relationship between management and shareholders only) as opposed to a more broadly defined version of corporate governance (so as to also include stakeholders such as employees, creditors and the wider environment).

[2] For the relation between the two in the EU countries, see the Communication from the Commission on Modernising Company Law and Enhancing Corporate Governance in the EU – A Plan to Move Forward (COM (2003) 284 final, Brussels, 21 May 2003).

bring about the desired effects and did not eliminate inefficient laws. The purpose of this paper is to provide a critical assessment of contemporary advanced theories within law and economics on corporate governance, with the aim of indicating their limitations which invite a further look at the evolution of corporate governance systems from the perspective of unconventional socio-legal theories.

The paper is structured as follows. The following chapter examines basic theoretical assumptions of conventional law and economics and new institutionalism. Chapter 3 applies law and economics theories to corporate governance and contrasts the two views on institutions. Chapter 4 discusses the literature on legal transplants and their relevance to corporate governance. Chapter 5 concludes.

2. From Conventional Law and Economics to New Institutionalism

Economics is described as a behavioural science that studies the logic of choice of economic agents under conditions of scarcity (Becker, 1976; Posner, 1977). As economists have recognised the need to take into account the impact of other social systems, and particularly the legal system, to enhance the understanding of the working of the economic system, economics has become increasingly concerned with the role that institutions play in coordinating the behaviour of economic agents. Although the origin of law and economics goes as far back as Adam Smith in the second half of the eighteenth century, [3] until around 1960 the economic analysis of law was very narrowly and almost exclusively confined to economic analysis of antitrust law; only after the pioneering work on social costs by Ronald Coase (1960) and Guido Calabresi's article on torts (1961) was economic methodology applied to a wide array of legal areas. The "new" law and economics evolved, characterised by an all-embracing application of economic analysis of law (Posner, 1977).[4]

Economic analysis of law studies the link between legal change and economic development, and analyses how economic agents behave in response to legal rules, and vice versa; that is, how legal rules are shaped. It advocates that legal

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[3] Smith, A., The Wealth of Nations, first published in 1776.

[4] In the 1970s, Posner's economic analysis of property rules and Calabresi's analysis of liability rules were taken further by Gary Becker, who extended the economic analysis of law approach to various non-market behaviours and institutions, such as marriage, divorce and racial discrimination (see Becker, G. 1976. The Economic Approach to Human Behaviour: University of Chicago Press.).

rules are best analysed in the light of standard economic principles. To this end, it utilises neoclassical behavioural assumptions of rational behaviour and wealth maximisation, and fundamental economic concepts such as value, utility and efficiency (Posner & Parisi, 2002). As illustratively described by both authors,

> "[l]aw and economics relies on the standard economic assumption that individuals are rational maximizers, and studies the role of law as a means of changing the relative prices attached to alternative individual actions. Under this approach, a change in the rule of law will affect human behavior by altering the relative price structure – and thus the constraint – of the optimization problem. Wealth maximization, serving as a paradigm for the analysis of law, can thus be promoted or constrained by legal rules" (Posner et al., 2002: xi).

Conventional law and economics is based on the premise that common law is efficient. In other words, the common law is the result of an effort to induce efficient outcomes (see e.g. Posner et al., 2002). This efficiency-of-the-common-law hypothesis is, to a great degree, based on Rubin & Priest's model of how law works. Rubin (1977) and Priest (1977) argued that the evolutionary selection of common rules is achieved through their efficiency, whereby efficiency of the legal norm is perceived as an ability to survive litigation. Private parties will have the incentive to contract around and litigate against the inefficient norms, thereby driving them out of existence.

While the early, conventional law and economics presented above proceeds under neoclassical assumptions of utility maximisation, rational expectations and optimal processing of information, and hence presumes full rationality of agents and their ability to respond and act perfectly, modern and more sophisticated law and economics rejects these assumptions. The new institutionalism in particular deals with objections to the neoclassical, rational actor model, by incorporating the notion of bounded rationality in its predictions (Jolls, Sunstein, & Thaler, 1998). It introduces the notion of agents' learning and emphasises the significance of habit, that is, the past actions of economic agents. From the behavioural law and economics viewpoint, economic actors learn from the past and from their past actions - they extrapolate from the past and tend to overvalue it. In other words, actors are conservative and are willing to pay the price for an asset in terms of its foregone utility. Behavioural law and economics, then, analyses the implications of actual human behaviour rather than the hypothesized one. A habit is identified as a key inertial element in the evolution of law (Pearson, 1997) and to deal with cognitive limitations of rationality and analyse bounded rationality, institutions are necessary.

3. Law as an Institution

3.1. Institutions as Exogenously Created Elements and the Evolution-towards-Efficiency Paradigm

As indicated, there are significant differences between the conventional and the behavioural law and economics with regard to the prediction of how institutions influence human behaviour, which are influenced by the concept of an institution itself. Accordingly, studies of corporate governance arrangements and capital market evolution reflect these divergences and are subject to different perceptions of an institution, as discussed below.

One group of authors within the law and economics has subscribed to the institution-as-a-player and institution-as-a-rule approach, which regards institutions as exogenously created, with their origin found outside the domain of the economy in which the rules are applied. Consequently, the issue of the origin and enforceability of institutions is encountered. Within this approach several studies have analysed the influence of law on the financial market and economic development. In relation to corporate governance and corporate finance, breaking empirical work was published by La Porta and co-workers in a series of analyses of the link between legal origin, investor protection, and corporate finance (La Porta et al., 1999; La Porta et al., 1997; La Porta et al., 1998; La Porta et al., 2000). These studies suggest that the quality of legal protection of outside investors matters for the evolution of liquid capital markets and the pattern of corporate finance (the "law matters" thesis).

La Porta et al. (1999) advocate the importance of law as a pivotal factor for economic development. They maintain that the quality of the legal environment has a significant effect on the size and breadth of a country's capital markets, and correspondingly on the ability of firms in that country to raise external finance (La Porta et al., 2000). Thus, the difference in the level of legal protection of investors might help explain why companies are owned and financed so differently in different countries, and accordingly, help explain the differences in the level of development of capital markets around the globe.

With respect to equity markets, the "law matters" thesis suggests that the level of development and breadth of equity markets are positively correlated with the level of minority shareholder protection. The better the shareholders are protected, the more developed the equity markets will be. In other words, in order to develop equity markets, a country must implement a specific set of legal rules governing companies and financial markets, thereby offering a

high level of protection to minority shareholders. An unregulated environment will not allow equity markets to evolve. The upshot is that if minority shareholders are not sufficiently protected by the legal regime, it is likely that they will be cheated by the company's executives or controlling shareholders (the company's insiders). As Cheffins (2001: 76) puts it, borrowing the terminology from Roe (2000), the law matters thesis argues that:

> "minority shareholders felt 'comfortable' in this sort of 'protective' environment. Such confidence meant that investors were willing to pay full value for shares made available for sale, which in turn lowered the cost of capital for firms that chose to sell equity in financial markets".

On the other hand, in countries where minority shareholders are not guaranteed a sufficient level of protection by the legal system, they will refrain from buying shares in securities markets, thereby discouraging companies to go public. As a result, insiders will decide not to sell shares to the public but will rather exploit private benefits of their control (such as voting rights and influence over the executives), and rely on different sources of finance. Equity markets will remain underdeveloped.[5]

In sum, the "law matters" perceives law and legal rules as rules of the game, as exogenously created institutions which define how economic agents will behave and, in turn, shape the evolution of capital markets. The thesis suggests that the ownership concentration is a response to weak shareholder protection. Thus, in the absence of quality corporate law, liquid equity markets are unlikely to evolve. [6]

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[5] The level of protection of minority shareholders against expropriation by insiders is measured by several shareholder rights under company law (La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R. 1998. Law and Finance. Journal of Political Economy, 106(6): 1113-1155.). These include rights such as cumulative voting, the one-share-one-vote rule, the ability of proxy voting by mail, the ability to retain control of shares during the shareholders' meeting, the possibility of calling an extraordinary shareholders' meeting, and oppressed minority mechanisms (such as class action suits). Together they form the so-called anti-directors index. For the evolution of liquid capital markets, it is important that these corporate law mechanisms allow shareholders to feel sufficiently confident to invest in publicly listed companies.

[6] La Porta et al.'s work (Ibid.), however, only relates to developed economies. For the purpose of defining the level of investor protection, the authors studied 49 developed countries, which proxies for legal protection. They classified them according to the origin of commercial law, as belonging either to the "common law" group or "civil law" group. Within the civil group, the classification was further extended into three common families: French, German, and Scandinavian civil family. The results of the study suggest that, in general, civil law countries have weaker shareholder protection and consequently smaller and narrower equity markets than common law countries, with French civil law countries being ranked the lowest. In their later work, the authors also indicated how transition countries would fit into their scheme, by

The "law matters" thesis has stimulated debate on the relative merits of the US/UK based shareholder model of company law and corporate governance[7] with a dispersed ownership structure and external financing through issuance of securities, vis-à-vis the Germany/Japan-based stakeholder model with concentrated ownership and bank financing. The argument as regards the dominance of the Anglo-American corporate governance model has, in turn, been linked to evolutionary theories and developed further by a line of authors who predict that economic forces will cause a gradual convergence of national corporate governance systems towards the most efficient, i.e. the shareholder model.[8]

This approach reflects the evolution-to-efficiency paradigm and advocates the perception of law as an institution that represents an efficient solution to resource allocation problems and that can, therefore, be readily adapted as deemed necessary to achieve efficiency. The agency theory, hence, presupposes a single optimal solution to the game; that is, a single optimal solution to the agent-principal problem. However, as indicated by Aoki (2001), there is a caveat to the agency theory approach - as it analyses the agent-principal relationship within a particular domain of the economy with institutional arrangements in other domains taken as a given and exogenous environment, its results may only be valid within an implicitly assumed institutional environment of the domain. This, in turn, necessitates caution in interpreting the results of the principal-agent model.

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briefly explaining historically influential legal systems in these economies. Accordingly, transition countries could be classified into one of the civil law families. The Czech Republic, Slovakia, Hungary and all constituencies of former Yugoslavia, for example, were heavily influenced by the German Commercial Code of 1897 and, therefore, belong to German civil law tradition countries. Poland, on the other hand, was influenced by the French Commercial Code and thus constitutes a French civil family. Nevertheless, this classification does not imply that the level of shareholder protection in transition economies, as measured by the quality of shareholder rights, does in fact correspond to the protection generally offered in these groups of countries (La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R. 2000. Investor Protection and Corporate Governance. Journal of Financial Economics, 58: 3).

[7] A pioneering work on US style corporations was done by A. Berle and G. Means, *The Modern Corporation and Private Property* (New York, Harcourt, Brace & World Inc., 1932)

[8] See, for example, the work of Hansmann and Kraakman (2001) for the "formal convergence thesis" (Hansmann, H. & Kraakman, R. 2001. The End of History for Corporate Law. Georgetown Law Journal: 439-468); and Gilson (2001) and Coffee (1999) who argue for functional, de facto convergence in companies' behaviour rather than for formal convergence of legal rules (Gilson, R. 2001. Globalizing Corporate Governance: Convergence of Form or Function American Journal of Comparative Law, 49: 329-357; Coffee, J. C. 1999. The Future as History: the Prospects for Global Convergence in Corporate Governance and its Implications. Northwestern University Law Review, 93: 641-707).

3.2. Institutions as Endogenously Created Elements

An alternative way of approaching institutions is to view them as being endogenously created through strategic interactions of agents, that is, to regard them as an equilibrium outcome of the game rather than as being generated from the outside. This perspective has been embraced by Douglass C. North who criticises the extension of the rational choice model and the evolution-towards-efficiency paradigm to institutional economic theory (North, 1990). The institution-as-an-equilibrium approach emphasises the humanly devised, endogenous nature of institutions and the significance of history in their evolution - institutions are creations made by human beings to generate order and reduce uncertainties in the exchange (North, 1990). It suggests that institutional arrangements can differ across economies even if they are exposed to the same technological knowledge and linked through the same markets, and hence indicates the possibility of multiple, suboptimal institutional arrangements. Consequently, this approach allows for consideration of the interlinkages and interdependencies of institutions operating across various domains within a specific economy and, in turn, suggests that only mutually consistent institutional arrangements may be sustainable in the economy (Aoki, 2001). The existence of several game equilibria as a result of the endogenous strategic actions of the players suggests that there are different forms of the agency problem, whereby the specific form that the agency problem takes is shaped by different historical factors. In other words, there is diversity to agency problems and, therefore, a diversity of solutions. There is no optimal solution to the agency problem, for it cannot be understood without looking at the context of different systems.

The context specific variety of the capitalism-based view of institutions has been taken up by Peter Hall and David Soskice who suggest that there is more than one path to a certain goal. Economy is regarded as a blend of various interest groups such as individuals, governments, producer groups and commercial companies, each having a unique position relative to institutional, cultural and historical factors influencing the development of a particular type of capitalism. Each type of capitalism is embedded in a particular social context of economy (Hall & Soskice, 2001). This path-dependent view of institutions contradicts the mainstream evolution-towards-efficiency paradigm. It suggests that constraints to which the rational actor must adjust are, to a large extent, the result of past choices; in Roe's illustrative words, "today's road depends on what path was taken before" (Roe, 1996: 643). Thus, the corporate structure of an economy at any given point is partially dependent on those that it had at earlier times (Bebchuk et al., 1999). Roe (1996) argues that the evolution-towards-efficiency paradigm itself cannot explain which institutions survived and how they survived.

Accordingly, he proposes the modification of the evolution-towards-efficiency explanation by means of integrating (i) chaos theory (that is, the initial and often accidental condition), (ii) path dependence, and (iii) modern evolutionary theory, which rejects the incremental view of evolution and suggests that changes occur during big upheavals and institutional crises after which institutions remain stable. Path dependence can occur in three forms: in a weak form it can explain the form of institutions which survive; in a semi-strong form it can lead to inefficient paths; finally, in a strong form, it offers path-created features, such as information and public choice that hinder the change.

Roe's theory of path-dependence and limits of corporate law rejects law and shareholders' protection as a factor of pivotal influence in developing equity markets, and explains the differences in the depth of the markets of the world's most developed nations by the deeply rooted political structures of these countries. Roe argues that there is a strong correlation between a nation's political orientation and its corporate ownership structure. Since a corporation is a part of the larger society, a corporate regime is not independent from other elements of the society. Instead, corporate governance systems are politically and ideologically dependent. More than just quality corporate law and protective legal institutions then is needed for a successful reform; suitable political and social frameworks must also be introduced. The technical reforms can, therefore, only have little effect unless the underlying political environment changes. Truly pivotal and fundamental elements for the development of equity markets are, thus, the "deeper features of society" (Roe 2003), such as industrial organisation, competition, and politics. These, however, are the elements that are much more difficult to control and change.[9] In line with this theory, reforms of corporate governance and company laws will not likely result in convergence of corporate governance systems across countries.

3.3. The Limits of Law and Economics

It follows from the discussion above that the law and economics approaches are sound at pointing to the need to have institutional structures which are mutually compatible. Moreover, as indicated, there is a discussion within

[9] See also Roe, M. 1994. Strong Managers, Weak Owners: The Political Roots of American Corporate Finance: Princeton University Press.; Roe, M. J. 2002. Corporate Law's limits. Journal of Legal Studies, 31: 233-267.; and Roe, M. J. 2003. Political Determinants of Corporate Governance. New York: Oxford University Press.

these approaches about convergence or divergence of national corporate governance systems, capital markets and company law. Nonetheless, there is a problem of transplantation of legal rules within law and economics, which is particularly acute in transition economies. Mainstream law and economics has not paid adequate attention to understanding how the process of transplantation works, nor has it answered the question of why certain institutions evolve somewhere and not elsewhere. The multiplicity of equilibria is generally regarded as bothersome by mainstream law and economics authors, and there is frequently a belief in a universal solution that is not sensitive to national conditions. This deficiency, as demonstrated below, is highlighted and its rectification offered in transition literature on legal transplants as well as in comparative institutional analysis.

4. Transition Literature on Legal Transplants

A growing body of transition literature that is analysing the transplant effect – that is, the unsatisfactory incorporation of formal legal norms – has evolved out of an attempt to deal with the integration of legal rules in transition and emerging economies which was proven to be unsatisfactory from the perspective of traditional law and economics. The transplant literature tackles the question of the efficiency of foreign legal elements that are being introduced in transition economies and tries to explain the apparent "lack of fit" between the intended effect of legal reform and the results they produced within the specific context of transition and emerging economies. To mention but a few scholars who have contributed to the transition literature, Berglöf and Von Thadden (2000) criticise the corporate "law matters" theory in the context of transition countries. They argue that La Porta's analysis with its focus on one group of corporate actors, small external investors only, is too narrow when applied to transition economies. As a consequence of concentrated ownership, in transition countries the main corporate governance conflict is not a trade-off between the interests of management and those of minority shareholders but rather a conflict between large block holders and minority shareholders.[10] As a result, the authors argue that policy recommendations should not simply be made on the basis of the law matters thesis but require definition of the corporate governance problem in each particular country with respect to its prevailing institutions. Investor

[10] For more on defining a main corporate governance trade-off in transition countries, see Berglöf, E. & Pajuste, A. 2003. Emerging Owners, Eclipsing Markets? Corporate Governance in Central and Eastern Europe. In P. K. Cornelius & B. Kogut (Eds.), Corporate Governance and Capital Flows in a Global Economy: 267-302: Oxford University Press. Authors argue that due to continuous trends in ownership concentration, the controlling shareholders will likely stay at the heart of the corporate governance regime in transition economies.

protection rules are generated by different legal systems and are highly complementary with other rules governing this system. The differences in the corporate governance problem in each country will, therefore, affect the implementation of policies to improve corporate governance.

In the same way, this problem was highlighted by Katharina Pistor and co-authors (2000), in a paper evaluating the "law matters" thesis from the perspective of transition economies. They extend the work of La Porta et al. (1998) by examining not only the quality of legal mechanisms for shareholder and creditor protection in transition economies, but also the effectiveness of enforcement of these mechanisms. They start off with indicators of investor rights developed by La Porta et al. (1998), but then extend them beyond the measurement of the shareholder-management conflict, so as to also encompass the relationship between minority shareholders and owners of large blocks of shares. Their results suggest that in transition economies enforcement of legal rules has a much higher explanatory power for economic development than the quality of legal rules themselves. By 1998 the level of shareholder protection in most transition economies was higher than in all three types of civil law countries from La Porta's sample, surpassed only by the common law countries. This is a result of drastic legal reforms that have been implemented in transition countries since the beginning of privatisation. It is suggested that pre-socialist legacies have not significantly shaped the extent of reforms, which indicates a tendency towards convergence of statutory law across transition economies (Pistor, 2004). While "law on books" is largely consistent with the legal practice of developed economies, the enforcement of the imported rules is often problematic (Berkowitz, Pistor, & Richards, 2003). In general, it is found that legal institutions in transplant (transition) countries are less effective than their counterparts in origin (developed) countries (Berkowitz, Pistor, & Richards, 2002). Hence, the low level of capital market development in transition economies is not attributed to weak "law on books", but is rather a consequence of the poor quality of the enforcement of legal rules. In La Porta's terminology, in transition economies not only the "law matters", but the "enforcement matters" as well.

To explain whether and why transplants work in some countries, Berkowitz et al. (2003) distinguish between receptive and unreceptive transplants. The two criteria for receptiveness employed by the authors are (i) familiarity and (ii) adaptation. The receptive transplant, such as foreign law imposed via colonisation, has similarities with the country from which it is borrowed and/or its transplantation to a domestic legal order necessitated significant adaptations to its initial conditions. Therefore, to be effective, argue the authors, legal reform should ensure that the law is adapted to local conditions

and familiarity with the law is increased before it is formally transplanted. Transition economies should, therefore, avoid simply "copy–pasting" foreign corporate governance practices but should instead adapt them to the local situation and take into account all relevant interest groups. Developing internally compatible rules and corporate practices that are tailored to specific local circumstances may well be the only effective method in the long run. In other words, to be well received and effective, laws need to be compatible with pre-existing social norms:

> "Where law develops internally through a process of trial and error, innovation and correction, and with the participation and involvement of users of the law, legal professionals and other interested parties, legal institutions tend to be highly effective. By contrast, where foreign law is imposed and legal evolution is external rather than internal, legal institutions tend to be much weaker" (Berkowitz et al., 2003: 189).

5. Conclusion

A variety of theories can provide a useful analytical tool to help understand the emergence of the existing regulatory framework of corporate governance. They range from classical economic approaches to law, through new institutionalism, behavioural science and theories rooted in politics, to the transplant literature, and by no means provide a fully coherent array of approaches to corporate governance. In certain aspects, these approaches are difficult to reconcile with one another, as the basic postulates on which the theories are based differ. In most aspects, however, these approaches can be viewed as complementary to each other, as each new strain was developed in response to limitations of the previous approach and its inability to satisfactorily explain the legal and economic changes taking place.

As demonstrated, economic approaches perceive law as an institution that provides the framework and the rules of the game – that is, a set of rights and obligations that affect people in their economic lives (Matthews, 1986; North, 1984). By shaping and constraining human behaviour, institutions provide a way to arrive at economic decisions in the real world (Hutchinson, 1984). Law and economics approaches, then, view law and economy as being inextricably linked and mutually constitutive. Through its set of rules, law directly influences and shapes economic decisions. Accordingly, institutions matter and so does the law.

Through these assumptions, law and economics predicts the ultimate synchronisation between law and economy – a point to point alignment. With reference to corporate governance, it is suggested that the adoption of better quality legal rules shall necessarily lead to greater liquidity of capital markets. Such an alignment of law and economy, in turn, implies the evolution of a neo-functional form of corporate governance arrangements which respond to the need of global capital markets.

These approaches, however, encounter problems of path dependence, and transplantation and transmission of norms, which invite a further look into the nature and evolution of legal norms. Having observed the frequent failure of laws to produce the intended effects and the persistence of inefficient laws, the evolutionary dynamics of approaches within law and economics led to an introduction of novel concepts, such as receptiveness, familiarity, adaptation, and internal process of development to which traditional law and economics has been oblivious. These new concepts indicate a tendency towards a fresh perspective on corporate governance that involves the study of institutional change and deals with questions that cannot be easily measured and quantified. Therefore, these questions are better examined by using the inductive and interpretive methodology of socio-legal theories than they would be by using econometrics, comparative statistics and other methods of quantitative economics employed by the economic analysis of law.

By way of an example, the modern theory of social systems and the related theory of autopoiesis can be resorted to as one of the alternative theories of the relation between the law and the economy. They employ concepts of system autonomy, operationally closed but cognitively opened social systems linked by mechanisms of structural coupling, and the notion of the mutual co-evolution of systems. From this standpoint, law and economy are perceived as separate social systems that are indirectly linked through specific communication mechanisms, that is, a process of structural coupling between the systems. Law and economics explains the inability of corporate governance reform to proceed as intended on the basis of diversity of systems, and blockages between law and economy in terms of path dependence and public choice-style inefficiencies. Autopoiesis, by contrast, points to a much deeper, structural problem of the separation of the legal and economic spheres, and their indirect, mutual co-evolution. It may well be that it thereby provides a richer theoretical resource from which to examine difficult issues of the law-economy interface in such areas as corporate governance. The understanding of these unorthodox theories and their implications, however, requires a detailed assessment of their premises. Such analysis, therefore, exceeds the scope of this paper. Instead, it shall provide a stimulating challenge for future research.

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