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A “Law & Personal Finance” View of Legal Origins Theory (forthcoming 2009 BYU L. Rev)

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A “Law & Personal Finance” View of Legal Origins Theory

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In two seminal papers,¹ Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny (LLSV) spell out a theory for the interrelationship between law and economic development now commonly referred to as “Legal Origins Theory.” Legal Origins Theory makes the following claims:

(1) There exist “legal families” that form separate and distinct sets of legal systems that are made up of groups of countries, *viz.*, Common Law countries (primarily Anglo-Saxon nations), Germanic Civil Law countries (e.g., Germany and Japan), and French Civil Law countries (e.g., France and most of continental Europe).²

(2) There is a significant correlation between a country’s “legal origin,” which group it belongs to, and the character of certain legal rules or procedures we find operating within that jurisdiction (e.g., judicial independence and contract enforcement, property right protection, minority shareholder protection, market vs. interventionist financial regulation, labor regulation, etc.).³

(3) These rules operate to advance certain economic ends, with rules/procedures that tend to favor market-based, individual contracting versus statist regulatory regimes which yield superior

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1. Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Legal Determinants of External Finance*, 52 J. FINANCE. 1131 (1997). A decade later, three of the four authors provided a restatement of their theory. Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Economic Consequences of Legal Origins*, 46 J. ECON. LIT. 285 (2008) [hereinafter La Porta et al., *Economic Consequences*].

2. See La Porta et al., *Economic Consequences*, *supra* note 1, at 287–91 (describing the concept of “legal families”).

3. See *id.* at 291–92 (describing the links between group membership and types of legal rules and procedures).

outcomes based on certain measures, such as market capitalization to GDP, income per capita, and others.⁴

(4) Membership in a legal family is exogenously determined (largely by the process of colonization and the assimilation/perpetuation of legal cultures by colonized jurisdictions). The distinct character of the broad legal families is a feature of history beginning as early as the middle ages and extending through the revolutionary era. Despite growing global convergence, these distinct characters persist and are significant; *and* these distinct characters are a significant antecedent cause of the types of legal rules/procedures found in a given country and, therefore, of the resulting economic consequences.⁵

What makes Legal Origins Theory so interesting is its claim to be more than simply a set of results. It claims to offer prescriptive value for policy development.⁶ Beyond simply offering a descriptive narrative of what legal choices in the past have led to the economic consequences of today, it purports to offer *ex ante* a narrative on what economic consequences will arise tomorrow from legal conditions today. Put crudely, if we were to form a new country today, we would see future outcomes determined by which legal family our new country belongs. These outcomes would be consistent with what we have seen in the past. Or so the Theory holds.⁷

This claim of inevitability may overstate, to some extent, the claims of the primary proponents of the Theory. Some have dubbed it the “strong form.”⁸ However, without some assertion of predictive value, the Theory becomes substantially less interesting. To say that certain good economic outcomes have come out of certain legal policies is, of course old beer. To be something more than another

4. *See id.* at 292–98 (reviewing the various empirical findings).

5. *See id.* at 306–09 (“[T]he empirical prediction of the Legal Origin Theory is that the differences between legal origins are deep enough that we observe them expressed . . . even after centuries of legal and regulatory evolution.”).

6. *See, e.g., id.* at 323–26 (describing Legal Origins Theory’s contribution to legal and regulatory reform).

7. *See id.* at 326 (“[L]egal origins . . . have significant consequences for the legal and regulatory framework of the society, as well as for economic outcomes.”).

8. *See, e.g.,* John Armour, Simon Deakin, Prabirjit Sarkar, Mathias Siems & Ajit Singh, *The Legal Origins Hypothesis: What are We Learning from Time-Series Evidence*, 2009 BYU L. Rev. (forthcoming Jan. 2010) (manuscript at 5, on file with authors). The obvious allusion to the various forms of the Efficient Market Hypothesis may indeed be telling.

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in a long line of law and economics papers, “law & finance,” as some have labeled LLSV’s work, needs to find a “big truth.” And like any assertion of discovery of a big truth, no matter how modestly stated, the assertions of Legal Origins Theory have attracted critics.⁹ I would join their ranks.

There are two aspects to Legal Origins Theory that I find the most difficult to accept. Professors Aguilera and Williams’ paper¹⁰ highlights one, Professor Fairfax’s,¹¹ the other.

The first feature I struggle with is the notion in the Theory that because we have found a causal channel that is significant *ex post*, we therefore have a predictive tool that allows us to set policy *ex ante*. LLSV revisited their theory in conjunction with the tenth anniversary of the publication of their first papers.¹² In their tour of the empire they had built, they purport to offer some humility regarding the predictive power of their work. Nevertheless, they conclude that legal origins have significant consequences for economic outcomes, and that the outcomes associated with the common law “family” are superior.¹³ All of this, despite an acknowledged inability to explain why France is a nice place to live.¹⁴

9. See, e.g., John C. Coffee, *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 59–71 (2001) (arguing that legal origins are not determinative of the development of deep capital markets); Raghuram G. Rajan & Luigi Zingales, *The Great Reversals: The Politics of Financial Development in the Twentieth Century*, 69 J. FIN. ECON. 5 (2003) (arguing that financial development is better explained by the ability of powerful incumbents to prevent openness in the marketplace to prevent competition); Mark J. Roe, *Legal Origins, Politics, and Modern Stock Markets*, 120 HARV. L. REV. 460 (2006) (post-war politics offers a better explanation than legal origins). Perhaps the least contestable lesson from Legal Origins Theory is one about academic strategy. If you have a choice in presenting your idea or your data results in an interesting but modest way or as a “big idea” with an aura of inevitability and great truth to it, pick the latter. Short of four letter words in your title, it is the most likely way to get you the download count you are looking for and the status of “academic rock-stars,” as Professors Aguilera and Williams put it. Ruth V. Aguilera & Cynthia A. Williams, “*Law and Finance*”: *Inaccurate, Incomplete and Important*, 2009 BYU L. REV. (forthcoming Jan. 2010) (manuscript at 9, on file with authors).

10. Aguilera & Williams, *supra* note 9.

11. Lisa M. Fairfax, *The Legal Origins Theory in Crisis*, 2009 BYU L. Rev. (forthcoming Jan. 2010).

12. La Porta et al., *Economic Consequences*, *supra* note 1.

13. *Id.* at 327 (“[O]ur framework suggests that the common law approach . . . performs better than the civil law approach.”).

14. *Id.* at 302 (“[C]ountries like France and Belgium achieved high living standards despite their legal origin.”).

I cannot help but wonder if the world can really be that simple. In a future that does not include two World Wars,¹⁵ in which men like Brandeis and Landis¹⁶ do not live in the times that these men lived, in a world where portfolio theory already exists and where globalization has become rampant and capital has become truly stateless, do the causal channels we discern for what has happened continue to exist in order to repeat what will happen again? Is it possible that the kind of historical events and figures that historians labor to elucidate can be so simply washed over by the ineluctable force of Legal Origins?¹⁷

Professors Aguilera and Williams' notion of *equifinality*¹⁸ captures the point well. The potential explanations are so varied and the interactions and path dependencies so complex, it simply defies belief that a set of regressions on a crudely defined "small-n" sample of "legal families" can be the basis for worldwide economic policy.¹⁹ We must allow complexity back into the narrative. Contingent details like the strength of labor movements, the presence of foreign investors, or the effects of war will matter.²⁰ In a complex global economy, where "New Multinationals"²¹ roam and arbitrage across borders is the name of the game, nation-state regimes are going to be under severe pressure, and, in my opinion, they will homogenize.²² Cross-country studies provide a very powerful tool for policy analysis—they always have. But like the language in the

15. See Roe, *supra* note 9 (arguing that the differing experiences of various nations in the aftermath of World War II offer a better explanation for the varying approaches to economic regulation).

16. Whatever one may say about the "great man" theory of history, it is difficult to ignore the impact of individual events and individual persons on the development of the laws that shape economic history. See generally THOMAS K. MCCRAW, PROPHETS OF REGULATION (1984) (describing the contributions of Louis Brandeis and James Landis in the development of the administrative state in the United States).

17. LLSV acknowledge that "[p]erhaps the most difficult challenge to the hypothesis . . . has been posed by historical arguments." La Porta et al., *Economic Consequences*, *supra* note 1, at 315. Nevertheless, LLSV have been adept at fitting historical counter-examples within their framework. See, e.g., *id.* at 315–23.

18. Aguilera & Williams, *supra* note 9 (manuscript at 3) ("[T]here are multiple paths to any given outcome.").

19. *Id.* (manuscript at 2) (calling the groupings of legal families "rather narrow").

20. *Id.* (manuscript at 3–4).

21. *Id.* (manuscript at 7) (describing the rise of the borderless enterprise as "the strongest robustness test to refute the hypothesis").

22. LLSV acknowledge this trend. See La Porta et al., *Economic Consequences*, *supra* note 1, at 327 ("There are many arguments for convergence.").

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front of a typical prospectus states, “past performance is no guarantee of future results.” Of course, we can only begin with past patterns to build our models. Many “smaller” LLSV projects—I like the ones about judicial independence, flexibility, and contract enforcement—have yielded a wealth of insights. But I agree with Professors Aguilera and Williams that the models will be more useful if they can embrace complexity.²³ That is certainly one lesson I take from our current crisis—it is the unexpected that often matters the most.²⁴

The second aspect of Legal Origins Theory I find hard to accept is its malleability. For example, I find less than convincing how LLSV’s 2008 paper argued that the rise of the U.S. regulatory state following the Depression—a highly statutory and interventionist regime in my opinion—was, in fact, actually an act consistent with the common law tradition and a free market bent.²⁵ I can easily agree that the New Deal legislation reflected “strategies intended to rehabilitate and support markets, not to replace them.”²⁶ But in doing so, what happens to the distinction between civil and common law styles? When does the creation of an administrative infrastructure, like the one we witnessed in the New Deal, stray from being a market-friendly, common law solution, to being a civil law, “state solution” that seeks to replace market forces? Similarly, Professor Fairfax’s struggle to situate the United States government’s recent responses to the financial crisis reveals another example of the indeterminacy of the labels used by LLSV.

To pick one example addressed by Professor Fairfax, consider the governmental response to the crisis at the nation’s banks. On the one hand, Professor Fairfax notes that the level of control taken by the Federal Reserve and the United States Treasury smacks of the kind of “nationalization” one associates with the statist approaches of civil law governments. As Professor Fairfax states, citing LLSV, “[t]he quintessential hallmark of a civil law system—and thus one of its

23. Aguilera & Williams, *supra* note 9 (manuscript at 8) (looking for “more nuanced institutional analyses”).

24. *See generally* NASSIM NICHOLAS TALEB, *THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE* (2007).

25. La Porta et al., *Economic Consequences*, *supra* note 1, at 308–09 (while acknowledging that the response was highly statutory and administrative, arguing that its essence was consistent with the common law’s pro-market character).

26. *Id.* at 308.

primary tools—is control of the banking system.”²⁷ Yet, only a few pages later, Professor Fairfax is forced to concede that “the characterization of our relationship with banks as nationalization appears to be exaggerated.”²⁸ She points out that the government has gone to great lengths to structure its “bailout” of the banking system on terms that approximate private, market transactions.²⁹

Generally, Professor Fairfax attempts to argue that the recent governmental response to the financial crisis is inconsistent with the predictions of the Legal Origins Theory. She argues that its features favor legislative or regulatory action³⁰ over judicial processes,³¹ and that they are marked by a stark growth in administrative authority.³² My suspicion is that LLSV would have no hesitation in reaching an opposite conclusion. Just as they felt able to explain the administrative state that arose in response to the Depression, I doubt they would have much difficulty in characterizing this last spate of government intervention in the markets as utterly consistent with their predictions. Professor Fairfax herself ends by concluding that “what emerges is a potentially mixed story.”³³ But if legal rules can be characterized so easily as one or the other—which I think they can—does this belie the premise of LLSV’s analysis?

In the end, however, I, like LLSV themselves,³⁴ believe the greatest challenge to Legal Origins Theory’s claim to big truth status must come from a more plausible, historical retelling of their story of cause and effect. I give you only a quick sketch of one explanation that appeals to me. I am going to call this the “Law & *Personal Finance*” School of Legal Origins Theory.

One challenge faced by every individual, and collectively by every society, is the management of what I visualize as a lifetime of cash flows. Over a lifetime, each of us sits at the center of a series of flows—money in and money out. As newborns we need cash for our sustenance, health, etc. We need cash for education, for shelter, and so on. As we enter adulthood, we start to begin to bring cash in

27. Fairfax, *supra* note 11 (manuscript at 38).

28. *Id.* (manuscript at 43).

29. *Id.*

30. *Id.* (manuscript at 33).

31. *Id.* (manuscript at 41–42).

32. *Id.* (manuscript at 35).

33. *Id.* (manuscript at 46).

34. La Porta et al., *Economic Consequences*, *supra* note 1, at 315.

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through earnings and, ultimately, through investment returns. Our challenge, however we may source or use these cash flows, is to have net cash flow equal to or exceeding zero over a lifetime *and* to maintain the required liquidity along the way that allows us to match in and out flows as they arise.³⁵ That's what savings and its corollary, borrowings, are for.

Now, recent events have highlighted two problems. First, many people in our society will not succeed in achieving a positive net lifetime cash flow without substantially changing their lifestyles or receiving outside help, and, second, many people today cannot solve the liquidity puzzle.³⁶ While these problems have been looming in the United States for some time, the crash in various asset markets has brought these issues to the point of crisis.

So, what does this have to do with Legal Origins Theory? Well, I see an answer in the concept of "equity culture." Equity culture is a phrase we once saw all the time in the early 1990s when American investment firms began assessing their global expansion priorities. A country like the United Kingdom, and more recently India,³⁷ was seen as promising investment territory because of its strong "equity cultures." Nordic countries were also seen as promising (although less so). Countries like Germany,³⁸ and especially France,³⁹ were distinctly less attractive despite the size of their economies because of their "lack" of an "equity culture." You will no doubt notice the

35. My favorite discussion of this challenge is found in JOE DOMINGUEZ & VICKI ROBIN, *YOUR MONEY OR YOUR LIFE* (1992).

36. See, e.g., S. Mitra Kalita, *The 'Democratization' of Credit is Over—Now It's Payback Time*, WALL ST. J., Oct. 10, 2009, available at <http://online.wsj.com/article/SB125511860883676713.html> (describing the over-leveraging by consumers and the impact of tightening credit).

37. See, e.g., Nandini Lakshman, *Private Equity Invades India*, BUSINESSWEEK, Jan. 8, 2007, at 40 (reporting on the influx of private equity investment into India).

38. See, e.g., John Eisenhammer, *View from Frankfurt: Learning How to Be Held to Account*, INDEPENDENT, Aug. 15, 1994, available at <http://www.independent.co.uk/news/business/view-from-frankfurt-learning-how-to-be-held-to-account-john-eisenhammer-atches-german-companies-try-to-cope-with-sharp-changes-to-share-trading-laws-1376584.html> ("The explanation lies in the fact that Germany is a different economy, one shaped by the relative lack of a dynamic investor culture. . . . Only recently, Rolf Breuer, chairman of the German Stock Exchange and a board member of Deutsche Bank, bemoaned the lack of an equity culture."); Phillip Moore, *Franz Takes to Equities, At Last*, EUROMONEY, Nov. 1994, at 83 (describing the rise of an equity culture in Germany).

39. See, e.g., Anne Swardson, *Cultivating a Taste for French Stocks*, WASH. POST, Nov. 17, 1999, at E1 (describing the lack of an equity culture in France).

confluence between Legal Origins Theory's map of "legal families" and this "equity culture" geography. They are the same.

Broadly put, "equity culture" measures the degree to which the investing public participates *directly* in risk capital markets.⁴⁰ In other words, to return to my story of lifetime cash flows, high equity cultures are markets where individuals attempt to solve their cash flow challenge by converting excess labor returns into risk capital returns by investing in equities.⁴¹ Common law countries, like the United States and Great Britain, have high equity cultures; civil law countries, like France, do not. So, do Legal Origins drive equity cultures? LLSV certainly suggest that they drive the rules that one would expect where equity culture flourishes.

But I am not convinced of the causal connection between Legal Origin and equity culture. In a world where cash flows travel with increasing ease across borders, why would we expect rules in one jurisdiction to affect demand (as opposed, perhaps, to supply) for equity investments? In other words, legal rules have more to say about what investment vehicles may be offered in a given jurisdiction, not necessarily about which investments savers in that jurisdiction choose to make.⁴² Since savers can access investment opportunities on a global basis, the rules of the jurisdiction in which they happen to live do not affect their choice, but rather, simply what kind of local options are available.⁴³ Equity culture, on the other hand, is about demand; it is about the choice individuals make in solving the cash flow problem.

40. See Michael Haliassos & Christis Hassapis, *Equity Culture and Household Behavior*, 54 OXFORD ECON. PAPERS 719 (2002) (describing the spread of equity culture in Western Europe).

41. Interestingly, recent studies suggest individuals are not successful in using the equity markets for building wealth. See, e.g., Yannis Biliias, Dimitris Georganakos & Michael Haliassos, *Equity Culture and the Distribution of Wealth* (Ctr. for Fin. Studies, Working Paper No. 2005/20, 2008), available at <http://ssrn.com/abstract=731805>.

42. In fact, much of the debate about regulation of financial markets before the recent crisis centered on the impact of regulation on the competitiveness of U.S. equity markets and on the global scene. See, e.g., Chris Brummer, *Stock Exchanges and the New Markets for Securities Laws*, 75 U. CHI. L. REV. 1435 (2008) (describing the proliferation of equity markets around the globe as creating a new market for regulation).

43. Another study makes a similar point in finding that parties to agreements that elect international arbitration as their mode of dispute resolution do not shun French law or favor common law to the degree that LLSV would suggest. Stefan Voigt, *Are International Merchants Stupid? Their Choice of Law Sheds Doubt on the Legal Origin Theory* (working paper, 2007), available at <http://ssrn.com/abstract=982202>. In other words, Legal Origins Theory does not explain the parties' demand for law of different legal families.

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This leads me to posit a different possibility. How does law affect demand rather than supply? I will propose two ways by which this may occur. One that I believe is only marginally important and the other counter-intuitive. Marginally important are taxes.⁴⁴ I say marginally because I suspect whatever choices any one jurisdiction makes to favor or disfavor equity through taxation can be arbitrated away by sophisticated investors.

The other, potentially more important, factor is a country's approach to social welfare. This coincides with Mark Roe⁴⁵ and others' political explanations, but is different in its locus of operation. This is not a battle between labor and elites. This is a battle between state and market-based finance.

In countries where education, healthcare, and retirement—the terrible trio of personal finance—are guaranteed by the state, in other words, where the state takes on the management of lifetime cash flow through taxation and subsidy, individuals can afford to shun the risk associated with equities.⁴⁶ As a friend once put it, “it's like work—why do it if you don't have to?” Instead, they favor cash, bonds, and hard assets. In countries where the safety net of state-based social welfare programs are weak, the need to overcome inflation and generate positive real returns to fund real future cash needs, like education, healthcare, and retirement, leads those who do save (and that's another problem) to invest in equities.⁴⁷

So, what does this mean for our assessment of Legal Origins Theory? Well, like Professor Fairfax's retelling of the current

44. See, e.g., Benjamin C. Ayers, C. Bryan Cloyd & John R. Robinson, “*Read My Lips . . .*”: *Does the Tax Rhetoric of Presidential Candidates Affect Security Prices*, 48 J. L. & ECON. 125 (2005) (finding that securities prices are impacted by changing market expectations regarding tax rates); Sandra Renfro Callaghan & Christopher B. Barry, *Tax-Induced Trading of Equity Securities: Evidence from the ADR Market*, 58 J. FIN. 1583 (2003) (finding that taxes on dividend income affect trading patterns around ex-dividend dates); Robert E. Hall & Dale W. Jorgenson, *Tax Policy and Investment Behavior*, 57 AM. ECON. REV. 391 (1967) (finding that tax policy impacts the level and timing of firm-level investments).

45. Roe, *supra* note 9.

46. You might argue that having a social safety net should allow individuals to take greater risk in their portfolios. This assumes, however, that individuals pursue wealth maximization as their investment goal rather than need satisfaction.

47. One recent paper comes to a similar conclusion, finding that the choice of state-based versus private pension funding is explained by antecedent inflationary shocks that have the effect of depleting the savings of the middle class. These shocks lead to a political preference for redistributive, publicly funded solutions. See Enrico Perotti & Armin Schwienbacher, *The Political Origin of Pension Funding* (working paper, Mar. 31, 2008), available at <http://ssrn.com/abstract=957752>.

regulatory response, this parallel narrative can be fit within the traditional Legal Origins story.

The general notion, that common law families tend to offer market-based solutions, is consistent with the description of the conditions likely to cause demand for equity. Also, the tendency to interventionist solutions does jibe with the high social welfare culture that leads to low equity demand. This parallel narrative also fits within the prescriptive narrative of LLSV by linking equity culture with economic growth. Equity culture certainly leads to larger and more dispersed capital markets, by definition. The availability of risk capital should also decrease the cost of capital, thus increasing investment and economic growth. The relative strength of venture capital in the Anglo-American world and its consequences for economic activity might be cited also (although I am not sure this fairly takes account of other forms of “venture” finance in, say, the Mittlestand in Germany or the “entrepreneur” communities in Italy).⁴⁸ Overall, you can see how we might fit this alternative narrative of “equity cultures” into the Theory’s prediction of superior economic outcomes for Common Law countries.

The explanatory efficacy of “equity culture” with regard to economic growth would fit nicely into the Theory’s predictive power, except for the one most glaring lesson I see in our current travails—leaving individuals and markets to solve the problem of lifetime cash flow does not look like it is going to work. They are not up to it. Enter here all the behavioral economists and the like.⁴⁹ But whatever the explanation—personally I’m happy with “it’s simply very hard”—people systematically fail. And so the question then becomes how to fix this. I would suggest that much of the mess we are in today stems from the market’s attempt to develop structures that are intended (genuinely or cynically) to address the problem of lifetime cash flows. It is what drives demand for so-called absolute return strategies. It lies at the center of securitization. It is what hedge funds, variable annuities, esoteric mortgages, etc. offer. It is a problem that can, in the end, only be solved by somebody investing

48. Professors Aguilera and Williams also note the ongoing debate over the performance of family-owned businesses. Aguilera & Williams, *supra* note 9 (manuscript at 5) (“[T]he jury is still out . . . on whether family-owned firms perform worse . . .”).

49. See, e.g., Henry T. C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777 (2000) (arguing that government may be complicit in creating an irrational faith in the equities as a savings device).

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in risk capital. The question is who? Individuals? The government? Or maybe something in between? LLSV seems to say that the only good answer is the common law's preference for "individuals and markets." Recent history, on the other hand, seems to suggest that the answer may not be so simple. We should hesitate whenever the simplification that often comes with a purported "big truth" asks us to ignore the messiness we so often see around us.

For all of its explanatory power *ex post*, I, like Professor Fairfax and Professors Aguilar and Williams, am not sure Legal Origins Theory has much to contribute to finding the right answers going forward for how we should organize our economic institutions. The recent crisis has certainly raised some doubt as to the ineluctable superiority of unregulated markets. Perhaps more fundamentally, it has caused some of us to re-examine the assumptions that underlie our definitions of success. Our faith in the linkage between financial markets and well-being has been shaken. To return to my story of life-time cash flow, we will ask again whether a society should measure success by how wealthy it becomes or perhaps rather by how many of its members do in fact achieve a positive lifetime cash flow. As Professors Aguilera and Williams point out, different measures of success—like measuring more than growth in financial markets—often yield outcomes quite contrary to the LLSV analysis.⁵⁰ While it is interesting to consider what role legal origins played in how we became what we are, it is much more important to consider now whether we continue to want to remain the same. I do not see how Legal Origins Theory helps in that decision.

50. Aguilera & Williams, *supra* note 9 (manuscript at 14–15) (“[T]he debates over the superiority of various systems of economic organization should not be considered over.”).