LAW & ENTREPRENEURSHIP: DO COURTS MATTER?

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In this essay, we sketch the outlines of a research agenda exploring links between courts and entrepreneurship. Our conception of “law and entrepreneurship” encompasses the study of positive law (including constitutions, statutes, and regulations), common law doctrines, and private ordering that relate to “the discovery and exploitation of profitable opportunities” by new firms.

We briefly survey the economics literatures that relate to law and entrepreneurship, including the “law and finance” literature launched by the work of Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (“LLSV”). Relying on the suggestive work of LLSV and other economists who have labored over the connections between entrepreneurship and law, we suspect that courts may play an important role in facilitating or hindering entrepreneurial activity.

We are particularly interested in the possibility that courts may facilitate the evolution of legal rules to address novel issues raised by entrepreneurial firms. This “adaptability hypothesis” may be subject to empirical testing, thus shedding light on the otherwise perplexing divide between common law and civil law countries identified by LLSV. The motivation for such a test lies in the conjecture that common law countries update their laws more frequently.

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than civil law countries through judicial intervention. Adaptability in this sense is said to encourage entrepreneurship because outmoded laws allow for opportunism, thus discouraging capital formation. The adaptability hypothesis implies that judges in common law systems have more room to maneuver than judges in civil law systems, and we describe the method by which we intend to approach our future study of adaptability.

Joseph Schumpeter famously identified the “process of Creative Destruction” as the “essential fact about capitalism.” In Schumpeter’s view, the entrepreneur is the agent of creative destruction, and the distinguishing attribute of entrepreneurial activity is novelty. Entrepreneurs create new products, improve the manufacture of existing products with new methods, exploit new sources of supply, and develop new forms of organization.

According to Schumpeter, entrepreneurial activity “constitutes a distinct economic function” because its very novelty ensures that it transcends the present body of understanding and because society resists novelty, thus requiring of the entrepreneur the distinctive skill of “getting

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1 JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY 83 (5th ed. 1976) [hereinafter SCHUMPETER, CAPITALISM]. Schumpeter developed the underlying concept in his Theory of Economic Development, where he referred to the “new combination of means of production” as the “fundamental phenomenon of economic development.”

2 SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT: AN INQUIRY INTO PROFITS, CAPITAL, CREDIT, INTEREST, AND THE BUSINESS CYCLE 74 (Redvers Opie trans., 3d prtg., Harvard Univ. Press 1949) (1934) [hereinafter SCHUMPETER, THEORY]. The word “entrepreneur” is derived from the French word entreprendre, which means “to undertake.” An entrepreneur, therefore, connotes “one who undertakes.”

3 JÖRGEN BACKHAUS, JOSEPH ALOIS SCHUMPETER: ENTREPRENEURSHIP, STYLE AND VISION 203 (Jürgen Backhaus ed. 2003) (arguing that Schumpeter’s entrepreneur bears a striking resemblance to the entrepreneur in the work of German economist Albert E. F. Schäßle).

4 See id. at 76 (distinguishing Say’s definition of “entrepreneurship,” which focuses on the combination of factors of production, on the ground that “this is a performance of a special kind only when the factors are combined for the first time—while it is merely routine work if done in the course of running a business”).

5 SCHUMPETER, CAPITALISM, supra note 1, at 132.
things done.” Schumpeter’s prediction that entrepreneurs would become obsolete seems passé in the wake of the revolutionary technological developments of the past few decades, but getting novel things done remains at the heart of modern conceptions of the entrepreneurial process.

Though entrepreneurship as a distinct field of research is still searching for an identity, entrepreneurship scholars gradually are forging a consensus about the core commitments of the field. In describing the entrepreneurial process, for example, scholars typically focus on “the discovery and exploitation of profitable opportunities.” Novelty is inherent in such opportunities.

6 Id. Schumpeter wrote:
To undertake such new things is difficult and constitutes a distinct economic function, first, because they lie outside of the routine tasks which everybody understands and, secondly, because the environment resists in many ways that vary, according to social conditions, from simple refusal either to finance or to buy a new thing, to physical attack on the man who tries to produce it. To act with confidence beyond the range of familiar beacons and to overcome that resistance requires aptitudes that are present in only a small fraction of the population and that define the entrepreneurial type as well as the entrepreneurial function. This function does not essentially consist in either inventing anything or otherwise creating the conditions which the enterprise exploits. It consists in getting things done.


8 See, e.g., Howard E. Aldrich & C. Marlene Fiol, Fools Rush In? The Institutional Context of Industry Creation, 19 Acad. MGMT. Rev. 645 (1994) (discussing the “relative lack of legitimacy” facing innovating entrepreneurs). Entrepreneurship scholars often emphasize the distinction between “invention” and “entrepreneurship.” Though both are forms of novelty— invention involves the creation of something that is new to the world, whereas entrepreneurship typically describes the process of commercializing a product or service—we are concerned only about the latter. For more on this distinction, see Schumpeter, Theory, supra note 1, at 88-89 (discussing entrepreneurship as a form of “economic leadership,” in which the entrepreneur “‘leads’ the means of production into new channels”).

9 See Henri A. Schildt et al., Scholarly Communities in Entrepreneurship Research: A Co-Citation Analysis, 30 Entrepreneurship Theory & Prac. 399 (2006) (concluding that entrepreneurship research remains “highly fragmented”).


11 Jonathan T. Eckhardt & Scott A. Shane, Opportunities and Entrepreneurship, 29 J. MGMT. 333, 336 (2003) (defining entrepreneurial opportunities as “situations in which
In this essay, we are not interested in refining the field of entrepreneurship per se, but in exploring the derivative discipline, “law and entrepreneurship.” And even in this limited endeavor, we will not attempt a precise description of the boundaries of “law and entrepreneurship,” but instead content ourselves with a sketch of the field based on our understanding of entrepreneurship, as described above.

We restrict our attention to “getting novel things done” by new for-profit enterprises. We do not discuss other forms of entrepreneurship, such as entrepreneurial activities by established firms or by non-profit organizations. The former is sometimes called “intrapreneurship.” Scholarly interests in intrapreneurship are clustered around the issue of how to circumvent organizational inertia in established firms and to get novel things done, as opposed to conducting routine business. Important issues in entrepreneurship by new firms arise from lack of experience and resources, which established firms usually possess. Given these significant differences between intrapreneurship and entrepreneurship by new firms, we gain little in the present context from mixing the two forms of entrepreneurship together.

Non-profit organizations, such as universities, also get novel things done. For instance, many important scientific discoveries emanate from university laboratories. Nevertheless, their motives and organization differ dramatically from for-profit enterprises; therefore, discussion of this form of entrepreneurship merits independent analysis.

Our conception of “law and entrepreneurship” follows naturally from the foregoing description of entrepreneurship and encompasses positive law (including constitutions, statutes, and regulations), common law doctrines, and private ordering that relate to “the discovery and exploitation of profitable opportunities” by new firms. While various disciplines study issues relating to entrepreneurship, such as the

new goods, services, raw materials, markets and organizing methods can be introduced through the formation of new means, ends, or means-ends relationships”.

12 Our use of the word “discipline” in connection with “law and entrepreneurship” is more an act of faith than of descriptive rigor. While we aver that “law and entrepreneurship” scholarship exists, it has yet to be organized as a discipline. For an early attempt to define the field, see Steven H. Hobbs, Toward a Theory of Law & Entrepreneurship, 26 CAP. U. L. REV. 241, 243 (1997) (focusing on “the study of law as it affects the entrepreneurial activities of small businesses”).

13 GIFFORD PINCHOT, INTRAPRENEURING (1985).

characteristics of entrepreneurs or the performance of entrepreneurial firms. Law and entrepreneurship studies should focus on the study of the optimal legal structures that facilitate the commercialization of entrepreneurial opportunities, as well as the regulation of entrepreneurial firms.

Given the traditional connections between economics and entrepreneurship studies, it is not surprising that the study of law and entrepreneurship has flourished among economists. They often focus on two legal issues that are critical for new firms attempting to get a novel

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At the most general level, entrepreneurship is the creation of value through the creation of organization. Entrepreneurs discover, invent, reveal, enact, and in other ways make manifest some new product, service, transaction, resource, technology, and/or market that has value to some community or marketplace. . . . The process of creating value operates through the creation of a multiperson system (organization) that transforms input such as materials, money, and time into output such as product and services. Excluded are the activities of the solely self-interested (the clever thief and the con artist) and those who create without deliberate and choiceful organizing of human resources (e.g., artists, inventors, and solo-self-employed professionals). Included are those who start a business or nonprofit agency and those who transform (acquire, redirect, restructure, and "turn around") existing organizations so they add new values to the community or marketplace.
thing done. First, such firms are heavily dependent on their novel ideas because they lack the physical resources possessed by established firms. As a consequence, economists often identify intellectual property protection as a key driver of entrepreneurship. Second, pursuing a novel idea often requires substantial amounts of money that is difficult for new firms to generate internally. Investors are willing to finance these firms only if they feel they are well protected from opportunistic behaviors by firms. Therefore, legal protection of investors is considered to be essential for nurturing entrepreneurship. In what follows, we first briefly review the economics literature on protection of intellectual property, then turn to the economics literature on investor protection.

Kenneth Arrow was the first to observe the difficulties faced by low-resource firms in appropriating returns from their novel ideas when intellectual property rights are weak. Arrow argued that attempting to sell a novel idea often is unfruitful because sellers can persuade potential buyers of the value of the idea only by disclosing the contents of the idea. Of course, potential buyers who acquire information in the course of such disclosure are unlikely to pay the original owner for the idea. Thus, to fully appropriate returns to novel ideas, those who generate such ideas may need to exploit the ideas without selling them to third parties. But exploitation of novel ideas often requires substantial resources unavailable to new firms. As a result, Joshua Gans and Scott Stern have argued that new firms benefit greatly from vigorous protection of intellectual property, which allows firms to sell their novel ideas profitably.

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18 See, e.g., Richard L. Smith & Janet K. Smith, Entrepreneurial Finance (2d ed. 2003) (illustrating the “S-curve” in new venture creation, showing that a new firm runs a substantial deficit due to the need to build or acquire physical assets, including office equipment and plants).
19 See, e.g., Richard C. Levin et al., Appropriating the Returns from Industrial Research and Development, 3 Brookings Papers Econ. Activities 783 (1987) (finding that large firms generally rate patents as less effective mechanisms of appropriation than the other means such as secrecy, lead time, and sales or service efforts, while startups typically do possess these appropriation vehicles because startups do not own their manufacturing and marketing capacities). For more on the difference in patent propensity between established and startup firms, see Wesley M. Cohen et al., Protecting Their Intellectual Assets: Appropriability Conditions and Why U.S. Manufacturing Firms Patent (or Not), Table 7 (NBER Working Paper 7552, 2000), available at http://papers.ssrn.com/so13/papers.cfm?abstract_id=214952 (finding that propensity to patent process innovations is negatively related with the presence of complementary sales and service assets, which new firms may not be able to afford).
20 See Smith & Smith, supra note 18.
Given that firms often disclose their ideas to potential investors, the problem identified by Arrow may also exist when new firms seek financing, rather than the sale of their ideas. Recognizing this potential for mischief, Masako Ueda also argues for vigorous protection of intellectual property rights. If intellectual property laws protect the novel ideas underlying entrepreneurial firms from expropriation by investors, such laws should increase financing options, thereby stimulating entrepreneurship.

Despite empirical support for this view, some authors emphasize the negative effects of intellectual property laws on entrepreneurship. For instance, Joshua Lerner claims, “First, as patents become easier to get, their value for the truly innovative firms—such as those backed by venture capitalists—decreases . . . . Second, young firms are frequently targets of patent litigation [by established firms].” The second point suggests that stronger protection of intellectual property rights may favor established firms more than entrepreneurial firms.

In addition to this ongoing debate about how protection of intellectual property influences entrepreneurship, economists have investigated how legal protection of investors affects entrepreneurship. Combined with the desire to get novel things done, limited internal financial resources often force entrepreneurial firms to seek outside financing. Nevertheless, the very novelty of the firm and its entrepreneurial idea may make it difficult for investors to assess the quality of the investment opportunity and to monitor the progress of the project once invested. If unaddressed, this asymmetric information problem would

25 For evidence supporting the role of patents in stimulating entrepreneurship, see Joshua S. Gans et al., When Does Start-Up Innovation Spur the Gale of Creative Destruction?, 33 RAND J. ECON. 571 (2002) (finding that start-up firms with patents, which are less likely subject to the appropriation problem, choose to commercialize through cooperation from established firms such as licensing); Bronwyn H. Hall & Rosemarie Ham Ziedonis, The Patent Paradox Revisited: An Empirical Study Of Patenting In The US Semiconductor Industry, 1979-1995, 32 RAND J. ECON. 101 (2001) (finding that the strengthening of US patent rights in the 1980s may have facilitated entry by specialized design firms during this period).
27 Related to this point, Ronald Gilson hypothesizes that enforcement of non-compete clauses in Massachusetts impaired the development of the Route 128 technology cluster as compared to Silicon Valley. Ronald J. Gilson, The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete., 74 N.Y.U. L. REV. 575 (1999).
create plenty of chances for entrepreneurs to act opportunistically.28 Foreseeing these potential pitfalls, outside investors would not provide the entrepreneurial firms with funds in the first place. Economists have argued that well-designed laws that protect investors may overcome this potential for underinvestment. This line of reasoning was initiated by a literature called “law and finance.”

In a series of articles beginning in 1997, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (“LLSV”) created a sensation among legal academics by proposing that “countries with poorer investor protections, measured by both the character of legal rules and the quality of law enforcement, have smaller and narrower capital markets.”29 LLSV’s argument began with this question: “Why do some countries have so much bigger capital markets than others?”30 That some countries have much bigger capital markets than others is uncontested. These large-market countries have more initial public offerings than other countries, and their corporations display dispersed ownership patterns indicative of the separation of ownership and control that has long dominated American corporate governance. Moreover, there is a high correlation between countries with these indicia of advanced financial development and countries with a legal system based on common law.31

The initial work of LLSV faced two major conceptual hurdles. First, LLSV observed a correlation between economic development and the common law tradition, but this merely prompted the question, “What is it about the common law, if anything, that fosters financial development?” Law professors have been extremely skeptical of a causal relation between the common law and financial development,32 but economists have made several attempts to address this issue. One hypothesis is that law is more

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30 Legal Determinants, supra note 29, at 1131.
effectively enforced in common law countries than in civil law countries. Simeon Djankov and three of the LLSV authors found that judicial procedures often are more complex and slower in civil law countries than in common law countries, suggesting that contracts in civil law countries may not be litigated to the same extent as in common law countries. More recently, the same authors have argued that restrictions on self-dealing often seen in common law countries are responsible for larger financial markets in those countries.

The second conceptual hurdle faced by LLSV was the notion that external investors actually relied on legal protections offered by the state. LLSV did not consider the possibility that external investors could compensate for gaps in legal protections via contract. The possibility of contracting creates two potential problems for LLSV: (1) parties in low-protection legal environments might contract for more protection; and (2) parties in a high-protection legal environment might contract out of certain protective provisions.

Investigating this issue in the context of venture capital contracting, some economists have found that contracts are substitutes for poor legal protections. For example, Steven Kaplan et al. studied the investment performance of venture capitalists in twenty-three countries outside of the United States and found that the legal origin of the host country (civil law versus common law) was not correlated with investment performance after controlling for characteristics of contracts. Accordingly, they concluded that “legal origins do not matter” but contracts do. Joshua Lerner and Antoinette Schoar analyzed 210 private equity investments in developing countries and found that private equity investors in civil law countries relied more on equity and board control than private equity investors in common law countries, suggesting that contractual provisions are substitutes for legal protection offered by the states. Despite concluding that contracts and positive laws may be substitutes, Lerner and Schoar also found that investment performance of private equity investment was better in common law countries than in civil law countries; therefore, their findings are consistent with the view that “legal origins matter.” Finally, Mihir Desai et

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33 For instance, a Nobel Prize Laureate Douglass North has argued, “how effectively agreements are enforced is the single most important determinant of economic performance.” DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE, AND ECONOMIC PERFORMANCE (1990).
35 Djankov et al., supra note 21.
37 Id. Interestingly, they find that venture capitalists that adopt U.S.-style contracts are less likely to fail.
al. found that in less developed countries, legal environments are important for the availability of external finance and thereby conductive to the healthy development of entrepreneurial activities.\textsuperscript{39}

Parallel with the law and finance literature, many economists have studied contracting problems between an entrepreneurial firm and its external investors. Each of these areas of study highlights a particular issue that arises from financing a new firm to get novel things done.

First, as we argued above, entrepreneurial firms often are highly dependent on their novel ideas, and they may have few physical assets. A large portion of the value of such a firm resides in human capital of the founders. Unlike physical assets, human capital is difficult for investors in the firm to possess and control. As a result, investors in entrepreneurial firms are inherently vulnerable to the threat by the founders to withhold their human capital from the firms. One solution for this problem is a bankruptcy law that is tough on debtors.\textsuperscript{40} Under such a law, the founders would be heavily penalized for withholding their human capital and bankrupting the firm. As a result, they might refrain from threatening to withhold their human capital, and absent such threats, investors would be more willing to finance firms in the first place.\textsuperscript{41}

A large body of literature on venture capital contracting implicitly assumes that professional venture capitalists (VCs) offer a solution to the problem of human capital withholding by founders. VCs provide not only money, but valuable advice and assistance to their portfolio firms.\textsuperscript{42} Like founders, VCs can threaten to withhold their valuable human capital, and this potential threat may counterbalance potential threats by founders.\textsuperscript{43}

This situation is essentially the same as a partnership or a joint venture in which two parties provide the venture with their human capital as well as other resources. Relying on this insight, Gilles Chemla et al. explain commonly observed terms in venture capital contracts and joint venture agreements.\textsuperscript{44} Also, using the same framework in a context where both a founder and a venture capitalist provide human capital, several

\textsuperscript{40} See, e.g., Lucian A. Bebchuk, Ex-Ante Costs of Violating Absolute Priority in Bankruptcy, 57 J. FIN. 445 (2002).
\textsuperscript{41} But see Kenneth Ayotte, Bankruptcy and Entrepreneurship: The Value of a Fresh Start, 23 J. L. ECON. & ORG. (forthcoming 2007) (arguing that applying absolute priority in bankruptcy strictly undermines the incentives of the firm to restructure and therefore may have a negative impact on the post-restructuring performance).
\textsuperscript{42} See, e.g., Thomas Hellmann & Manju Puri, Venture Capital and the Professionalization of Start-up Firms: Empirical Evidence, 57 J. FIN. 169 (2002).
\textsuperscript{43} Yeon-Koo Che & Jozsef Sakovics, A Dynamic Theory of Holdup, 72 ECONOMETRICA 1063 (2004).
\textsuperscript{44} Gilles Chemla et al., An Analysis of Shareholder Agreements, J. EURO. ECON. ASSOC. (forthcoming Mar. 2007).
studies have offered an explanation for the frequent use of convertible securities in venture capital contracts.  

Second, novel ideas often fail. Founders may resist shutting down their firms, even when prospects are bleak. As a result, the financing of entrepreneurial firms typically includes a mechanism to halt excessive continuation by the founder. Dirk Bergemann and Ulrich Hege argue that staged financing performs this function, and Thomas Hellmann contends that shifting control rights from the founder to the financier when the venture is not progressing well. Gordon Smith discusses both staged financing and shifting control rights as sources of VC power.

In addition to the law and finance and contracting literatures surveyed above, a number of articles stress the importance of well-developed stock markets for entrepreneurship. These studies fall into the category of “law and entrepreneurship,” assuming the importance of legal environment for the development of stock markets, as posited in the law and finance literature. Two distinctive arguments connect stock markets and entrepreneurship.

First, several commentators claim that stock markets allow VCs to exit their investments, recycling their value-added services. Under this view, active stock markets not only encourage new firms to go public, but also enable established public firms to acquire new firms by using stock. VCs can sell their shares into active stock markets, and in the absence of such markets, VCs suffer from illiquidity discounts when they attempt to sell their shares. This illiquidity discount reduces the expected return to

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46 See, e.g., Boyan Jovanovic, Selection and Evolution of Industry, 50 ECONOMETRICA 649 (1982) (arguing that a new firm enters a market without knowing its profitability and learns about it over time).


venture capitalists, making them less likely to invest in new firms in the first place.

Second, a novel idea and the firm that conceives it may initially have difficulty finding supporters. Such supporters may be more likely to connect with innovative firms through stock markets, which are populated by investors of diverse interests. Franklin Allen and Douglas Gale have stressed this role of stock markets in bridging between entrepreneurial firms and investors who appreciate and support the firms. 51

As evidenced by the foregoing discussion, entrepreneurship and law have many potential contact points, but one feature of the legal system is pervasive: courts. Whether acting as the interpreters of intellectual property or securities laws, as the architects of judicial doctrines such as fiduciary duty or the contractual duty of good faith, or as the arbiters of contract provisions, courts may have an important influence over the level of entrepreneurship in a given region or country. 52

We are particularly interested in the possibility that courts may facilitate the evolution of legal rules to address novel issues raised by entrepreneurial firms. This so-called “adaptability hypothesis” is itself not novel, 53 but we are intrigued by the possibility that judicial adaptability might be tested empirically, thus shedding light on the otherwise perplexing divide between common law and civil law countries. The motivation for this test lies in the conjecture that common law countries update their laws

52 For examples of various ways in which courts might influence level of entrepreneurship, see Jean O. Lanjouw & Josh Lerner, Tilting the Table? The Use of Preliminary Injunctions, 44 J. L. ECON. 573 (2001) (arguing that cases involving new technology are often settled in courts due to uncertainty over the judicial outcomes); Vladimir A. Atanasov et al., VCs and the Expropriation of Entrepreneurs (Working Paper, 2006), available at http://ssrn.com/abstract=905923 (showing that VCs who had been sued by entrepreneurs subsequently raised less capital and participated in fewer syndicated deals, suggesting that the opportunity to bring complaints to courts may play a disciplinary role).

Another familiar leitmotif of the legal origins literature is that civilian legal regimes are perversely formalistic, and that this is a problem that reformers of civilian regimes need to overcome. . . . This feeling seems to strike every common lawyer first encountering a civilian system, as it seems to strike nonlawyers who start looking closely at any legal system. For example, an attack on civilian formalism was an important strain in the Law and Development movement of the 1960s and 1970s, many members of which were Americans attempting to modernize civilian regimes in the Third World.
DO COURTS MATTER?

more frequently than civil law countries through judicial intervention. Such adaptability is said to encourage entrepreneurship because outmoded laws allow for opportunism, thus discouraging capital formation. The adaptability hypothesis implies that judges in common law systems have more room to maneuver than judges in civil law systems.

The adaptability hypothesis may appear to produce some tension with the notion that businesses value “calculability” or predictability. This idea was important to Max Weber’s account of capitalism, and it arises among modern legal scholars in various contexts. The perceived tension between these ideas exists only to the extent that one insists on complete stability or complete adaptability, but realistic accounts of the judicial process acknowledge both elements.

54 Thorsten Beck et al., Law and Finance: Why Does Legal Origin Matter?, 31 J. COMP. ECON. 653 (2003). The French situation encouraged the development of easily verifiable “bright-line-rules” that do not rely on the discretion of judges. While simple and clear, some scholars argue that bright-line-rules and excessive judicial formalism may not allow judges sufficient discretion to apply laws fairly to changing conditions and therefore not support evolving commercial needs. Simon Johnson et al., Property Rights and Finance, 92 AMER. ECON. REV. 1335 (2002). In contrast to the French civil law, the English common law tradition is almost synonymous with judges having broad interpretation powers and with courts molding and creating law as circumstances change.

55 H. PATRICK GLENN, LEGAL TRADITIONS OF THE WORLD 136 (2d ed. 2004). Glenn describes this notion as follows:

If everyone has pre-defined rights (which do not in any way depend on judicial determination), then their violation may exist prior to judgment, and the judicial function is largely one of verification of claims of violation of pre-existing rights, and remedying the violations.

Id. at 146.


58 See, e.g., Allan C. Hutchinson, Work-In-Progress: Evolution and Common Law, 11 TEX. WESLEYAN L. REV. 253 (2005) (noting that “the pressing challenge” of the common law system is “to balance stability and continuity against flexibility and change such that it results in a state of affairs that is neither only a case of stunted development nor a case of ‘anything goes?’”).
We conceive of the adaptability of courts along two dimensions: interpretation and innovation.\(^5\) Interpretation is central to the judicial role. Indeed, Kathleen Sullivan has observed that law “is a branch of rhetoric that gives normative force to interpretation and analysis.”\(^6\) Methods of interpretation may vary depending on the source of law, and theories of interpretation are legion.\(^6\) For purposes of evaluating legal adaptability, however, we could avoid debates about the relative merits of various interpretive theories, focusing instead on the expressed interpretive strategies as applied by courts to claims in litigation. Stated another way, adaptability is about courts keeping pace with changes incited by entrepreneurial firms, and we would expect to see some evidence of judicial adaptability in the pronouncements of judges. In testing judicial adaptability, therefore, we would turn to judicial opinions as a source of data.

In examining the judicial opinions, we would find interpretations of constitutions, statutes, regulations, other judicial opinions, and contracts. By coding each interpretive act (say, according to the litigated claims), we should be able to obtain a measure of adaptability. For purposes of illustration, we rely here on Eskridge and Frickey’s oft-cited article on statutory interpretation,\(^6\) which describes three theories of statutory interpretation.

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\(^5\) Our discussion here focuses on laws, not facts. We acknowledge the possibility that courts may adapt to technological or business innovations by creatively framing the facts underlying the disputes before them, but the adaptability hypothesis does not focus on this sort of adaptation as a potential source of meaningful differences between common law and civil law countries.


interpretation: textualism, intentionalism, and purposivism. We discuss each theory briefly below.

All sources of law require interpretation. Even when words appear to have a “plain meaning,” that meaning depends on both culture and context. As Judge Learned Hand famously wrote: “Words are not pebbles in alien juxtaposition; they have only a communal existence; and not only does the meaning of each interpenetrate the other, but all in their aggregate take their purport from the setting in which they are used. . . .” Nevertheless, many statements of law have meanings about which the legal community has reached a high level of consensus. Moreover, even in the absence of consensus, judges frequently assume that the relevant legal standards have a more-or-less fixed meaning. When judges analyze claims in this way, they are employing a “textualist” theory of interpretation.

In other circumstances, judges may perceive the need to pursue a more contextual interpretation. One method of evaluating context is to examine the history and development of the relevant legal authority. In some instances, the legal authority was created long before the occurrence of the dispute, and the text may have developed new and different meanings during the interim. In any event, historical reference can aid courts in ascertaining the intention of the lawmaker, whether that is a legislature, a court, or a private party. When judges analyze claims in this way, they are employing an “intentionalist” theory of interpretation.

Another contextual approach to interpretation inquires after the purpose underlying a legal rule. Like appeals to structure, this tool attempts to acknowledge the hand of the lawmaker, whether that is the legislature, a prior court, or the contract drafter. Purposes may be discovered or inferred. When judges analyze claims in this way, they are employing a “purposive” theory of interpretation.

These various interpretive theories are not mutually exclusive. Judges often use more than one theory on a legal authority to bolster the persuasiveness of their chosen interpretation. The diversity of interpretive methods suggests that judges possess substantial discretionary power and we would expect to observe such discretion in all legal systems. As noted by Judge Cardozo, “You may call [the judicial] process legislation, if you

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63 NLRB v. Federbush, Co., 121 F.2d. 954, 957 (2d Cir. 1941).
65 Eskridge and Frickey endorse this more holistic approach to interpretation: “by bringing all the relevant factors and all of our problem-solving skills to bear on difficult questions of statutory meaning in concrete situations, practical reasoning legitimizes statutory interpretation through deliberation and candor.” Eskridge & Frickey, supra note 62, at 383.
will. In any event, no system of *jus scriptum* has been able to escape the need of it.\(^{66}\)

In addition to the interpretive theories just discussed, we acknowledge the possibility that judges will depart from interpretation and create new legal rights or obligations. The adaptability hypothesis stresses the role of common law judges in shaping the evolution of laws in line with ever-changing business needs and practices, and though common law judges have substantial discretion, we would expect innovative actions to be less common than interpretive creativity. Nevertheless, claims based on doctrines such as common law fraud, fiduciary duty, or the duty of good faith and fair dealing seem particularly ripe for judicial innovation. Such doctrines are considered to be an essential vehicle for U.S. law to evolve quickly according to business needs.\(^{67}\)

Even if courts supplied adaptations to the legal system, there is no guarantee that the adaptations would be entrepreneurship enhancing. Whether adaptations aim to enhance entrepreneurship may depend on levels of judicial independence. Some scholars have suggested that judges in common law countries are more independent of politics than judges in civil law countries.\(^{68}\) Politics often are heavily influenced by established firms, which tend to discourage the development of financial markets, which in turn facilitate the entry of new firms and invite competition. The implication is that judges in civil law countries may discourage capital formation.

In the latter part of this essay, we have sketched the outlines of a research agenda exploring links between courts and entrepreneurship. Relying on the suggestive work of economists who have labored over the connections between entrepreneurship and law over the past decade, we suspect that courts may play an important role in facilitating or hindering entrepreneurial activity. Of course, speculating about adaptability and testing the adaptability hypothesis are quite different matters. We recognize that the methodological challenges inherent in our project are ample, though we take refuge in the advice of one of our senior colleagues, who observed, “You can’t do this, but you must do this.”

\(^{66}\) **Benjamin N. Cardozo**, *The Nature of the Judicial Process* 16 (1921).