

A review on La Porta's oeuvre

1. Some theoretical and practical aspects of Rule of Law and Welfare State

1.1. Theoretical views on the Rule of Law

Most generally the meaning of this legal expression was given by Tamanaha: „... There are almost as many conceptions of the rule of law as there are people defending it”. Tamanaha gives us a guideline in a recent insightful intellectual history of the rule of law:

Some believe that the rule of law includes protection of individual rights. Some believe that democracy is part of the rule of law. Other believe that the rule of law is purely formal in nature requiring only that law be set out in advance in general, clear terms, and be applied equally to all. Others assert that the rule of law encompasses „the social, economic, educational, and cultural conditions under which man's legitimate aspirations and dignity may be realized”...

In a liberal democracy majorities will always find ways to argue that, weighing the interests of all individuals concerned, just treatment requires that semantically general rules be such that are in favor of the majority.

Contrary to the abovementioned, some China law expert state: „The rule of law means whatever one wants it to mean. It is an empty vessel that everyone can fill up with their own vision”

Raz suggest a short, but meaningful idiom of the Rule of Law: „people should obey the law and be ruled by it”. But what is law? According to Locke, law is both those rules to which we bind ourselves through the social contract and those rules formulated by the sovereign in accordance with that contract.

Dicey adds the following: „every man, whatever his rank or condition, is subject to the ordinary law of the realm and amendable to the jurisdiction of the ordinary tribunals”

When giving more special meaning to the idiom we will meet a „thick” conception: Hayek links the Rule of Law to freedom: „...when we obey laws, in the sense so general abstract rules laid down irrespective of their application to us, we are not subject to another man's will and are therefore free.”

Equality –mentioned in Tamanaha's guidelines- is not anymore defined in relation to the individuals' personal situation, individual welfare, utility and the like, but rather in a schematic way neglecting inter-individual differences. In the formulation of rules equality takes precedence over considerations of justice.

The „thin” concept can be characterized by Rawls's view: „the Rule of Law stands merely for the principle that rational people need a predictable system to guide their behaviour and organize their lives in a way that minimizes unproductive conflict with other agents.”

Raz goes on to suggest an itemized outline, each correlating the the law's coordinative function:

1. All laws should be prospective, open and clear
2. Laws should be relatively stable
3. The making of particular laws (particular legal orders) should be guided by open, stable, clear and general rules
4. The independence of judiciary must be guaranteed
5. The principles of natural justice must be observed
6. The courts should have review powers over the implementation of the other principles
7. The courts should be easily accessible
8. The discretion of the crime-preventing agencies should not be allowed to pervert the law

The rationality of Rawls and procedural statements made by Dicey are combined in Harry W. Jones's concept, where the third requirement for the Rule of Law's „American version” is:

„... day-to-day decisions shall be reasoned, rationally justified, in terms that take due account both of the demands of general principle and the demands of the particular situation”

1.2. Practical approach: Welfare state vs. Rule of Law?

After the Rule of Law being defined on a theoretical playground, problems will occur in interaction of the identifying characteristics of the welfare state that are chiefly the following:

1. there is a vast increase in the range and detail of government regulation of privately owned economic enterprise
2. the direct furnishing of services by government to individual members of the national community-unemployment and retirement benefits, family allowance, lowcost housing, medical care, and the like
3. increasing government ownership and operation of industries and business which, at an earlier time, were or would have been operated for profit by individuals or private corporations

Kelsen remarks with his usual clarity of analysis, the contention that the rule of law cannot be maintained in a welfare state.

He is not alone with his opinion: *Hayek* in „*The Road of Serfdom*” says that the welfare state is a deadly enemy of the rule of law. „ Any policy aiming directly at a substantive ideal of distributive justice must lead to the destruction of the Rule of Law” -this striking passage seems to condemn St. Thomas Aquinas equally with Harold Laski.

In *Hayek's* analysis, discretion is equated with arbitrariness; there is no concession that discretionary power may be exercised in other than arbitrary way.

Therefore those who object to redistribution per se will not be satisfied by the requirement of schematic equality of rules. Still, imposing the constraint of schematically equal treatment on central law enactment should have strong appeal from the point of view of the adherent of a constitution of liberty as one minimum requirement. It closes off some of the abuses of legislative powers underlying the regulatory and redistributive politics of our days. However, regardless of its advantages, there remains a severe problem for the proposed strong interpretation of Hayek's views on generality. In financing redistribution we evidently cannot stick to the same per capita scheme of equality. We cannot use a per head tax. If we imposed the requirement of schematic equality on financing then redistribution would be impossible altogether. If we want to live in a state in which rule of law in the sense we are used to prevails then we cannot but tax differently.

Like many libertarian subscribers to natural rights views one might want to claim here that this is all too well because a constitution of liberty is completely incompatible with redistribution anyway.

To solve this problem it would be a great step towards a constitution of liberty if central legislation would be confined to truly general rules. These would close off to the possible extent preferential treatment of groups or individuals by the law, and lead to formal equity.

Tamanaha's truly general rules raise the question of their applicability. According to Jones the perfection of formal equality is an abstraction that practical justice blows away, as it always has and must. The attainable ideal is that all laws should apply equally to all human beings unless, as Julius Stones puts it, „there is good reason to the contrary". The individualization of punishment in criminal law is a trivial example for that.

The question is what kind of economical characteristics are associated with the welfare state concept. Although, the authors majority identifies the welfare state as a capitalist state, according to their identifying characteristics of the welfare state given by Jones, this conclusion can be falsely discriminative.

Contrary to Kelsens opinion Jones argues that „political freedom weighs even heavier in the scale than economic organization. It is an unexpressed premise of the western unity that the socialist democracy has far more in common with a capitalist democracy than it has with socialist dictatorship and that a capitalist democracy has far more common with socialist democracy than with a capitalist dictatorship.

The requirement of true generality law would presumably not solve all our problems of redistributory and regulatory politics. Additional more conventional measures of federalizing the legal order and of decentralization of the evolution of law should be taken into account as well.

The solution for all the ambiguities, doubts and controverses can be the office of the welfare state as the source of new rights –for example the expectations created by comprehensive system of social insurance. The word „right" can not only be used in connection with such traditional interests as those in tangible property, but for the new expectations. For example the typical middle income American reaches retirement age with a whole bundle of interests and expectations: as home-owner, as small investor, and as social security beneficiary.

In an era, when rights are mass produced, where a thousand times as many deciding officers are needed than before to settle the issues presented by the claimants

their protection against arbitrary official action may less widely dispersed among the members of the society.

Every modern western legal order makes use of an extended system of courts which in one way or other develop the law by means of interpretation. However the extent to which central rule enactment interferes with such processes varies. In fact in most western legal systems the role of the courts as decentralized sources of new law is restricted by stronger and stronger central intervention.

It becomes the task of the Rule of Law to surround the „new rights“ with protection against arbitrary government action, with substantive and procedural safeguards.

2. The theoretical and empirical background of capital market structures

2.1. The *La-Porta* analysis

Rafael La Porta and his working group analysed in 49 countries of the world the ownership concentration of listed corporations, the investor and creditor protection regimes and the prevailing of the rule of law. The thoroughness of the analysis is demonstrated by the fact that the findings were summarised in indices and graded the countries that were subject of the analysis pursuantly. The different legal families (common law, German, French, and Scandinavian civil law) were graded as per the points received by the states that belong to the respective family. In our case, perhaps the most interesting method is the one that was applied in the field of shareholder rights.

La Porta and his working group identified eight legal considerations as the guarantee of prevailing shareholder rights. The larger part of these considerations has the overall name of *Antidirector Rights*. Of these, six considerations are placed in a quite simple evaluation system, which are in order a) the principle of one share one vote, b) proxy by mail allowed, c) shares not blocked before shareholders' meeting, d) cumulative voting/proportional representation, e) oppressed minority f) pre-emptive rights of acquiring newly issued securities. If one given consideration is applicable pursuant to the laws of the respective state, *La Porta* and his working group grant one point to the state, whereas zero, if the laws do not guarantee the given consideration. The situation is more complex in the case of the right to convene the shareholders' meeting. Here those states get a point, in which the laws enable shareholders holding 10% (or less, 10% is a medium figure in a worldwide comparison) of the ownership to exercise this right. In the end *La Porta* and his working group also estimated if it was mandatory to pay dividends to the shareholders, and if it was, then in what proportions. The index of the table produced a great variety of results. Belgium's performance was bewilderingly poor, it received zero points, while the United States or Canada were the proud owners of 5 points. On the basis of this index, the authors drew their conclusions with regard to the prevailing of shareholder rights (on the level of states and of legal families as well); and also compared their results with similar indices of other fields (creditor protection, rule of law, ownership concentration).

The method in the field of creditor protection is quite similar, considerations worth either one or zero points are the followings: a) the reorganisation procedure does not impose an automatic stay on the assets of the firm upon filing the reorganisation petition, b) secured creditors are ranked first in the distribution of the proceeds that result from the disposition of the assets of a bankrupt firm, c) mandatory reorganisation procedure, d) the management does not stay in its position in case of reorganisation.

The analysis of capital protection was carried out by the lines of different factors, just the same as the estimation of mandatory dividend in the index in case of shareholder rights.

In assessing the rule of law, the previously used 0 or 1 point index was not applied. Besides efficiency in the judicial system, considerations included the binding force of judgements, the risk of expropriation, corruption and the risk of violation of contracts. Additionally, *La Porta* and his working group listed in this category the conformity with accounting standards as well.

The considerations of the index of ownership concentration were defined by the authors that they observed the average and the median of the percentage of shares held by the three largest shareholders of the ten largest listed companies in each country. The average market capitalisation of the company was also indicated in the table.

Having compared the results, *La Porta* and his working group identified three main conclusions. The first one was that although legal regimes are different worldwide, they all offer only limited guarantees to the investors. The members of the common law legal family excelled, whereas countries with Roman law traditions had worse results (within that group, laws of German origin were mediocre, while laws of French origin showed a clearly poor performance).

The second conclusion was that the rule of law is diverse all over the world. The best results in this field were achieved by the German legal family, common law legal regimes were in the mid-range and legal systems of French origin came in last again.

Thirdly, *La Porta* and his working group concluded that investor protection shows a weakening tendency worldwide, which they thought to be originating in high ownership concentration. They demonstrated that there was a direct relationship between the efficiency of investor protection and the level of ownership concentration: the less investor protection is offered by a state, the higher is the ownership concentration. In the light of the above, *La Porta* and his colleagues disagree with those opinions that consider the plural shareholder structure of the United States as a consequence of the American-style "anti-blockholder" policy. *La Porta* and his working group also emphasised in this context that dominant *blockholders* do not support – what is more, they hinder – legal reforms that could be the foundation of a wider shareholder democracy. If we consider how ponderous the corporate governance of the European Union is, it is easy to see that the authors could not have been greatly mistaken in this regard.

The final conclusion of the above is that legal solutions are closely connected to the aspects of economic development. The chances of error deriving of the subjective aspects of the research results have been highlighted by the authors themselves, pointing out that for example Belgium and France had not achieved very good results in their survey, they are still very rich countries. Nevertheless, the final observation of the *La Porta* study is that investor protection has a decisive impact on the ownership structure of companies, and also has a great influence on financial processes, and last but not least, it significantly affects the growth of companies and the development of capital market conditions.

Still we should note that the social, economic and legal contexts of certain legal concepts are always too compound to entirely accept the "evidence" listed by *La Porta* and his working group.

2.2. Interpretation of differences in capital market structures from the perspective of 20th century history and politics

The examination from a historical perspective the economic system of the countries whose laws originate in the common law or the civil law may give rise to doubts about the adequacy of the differences established by La Porta and his team between the various legal families. For instance, according to the analysis prepared by Mark J. Roe, professor at Harvard Law School, before World War I the budgetary expenditure of common law countries in proportion to their GDP reached or exceeded the level characteristic of civil law countries. According to his study, before World War I, civil law governments had modest roles in their economies, and the appearance of significant budgetary domination can be dated to the second half of the 20th century. Moreover, he emphasizes that in a historical context civil law countries do not show a higher propensity than common law nations to redistribute income, wealth, or property. Civil law nations did not redistribute noticeably more than common law nations until the latter part of the twentieth century. Moreover, stock and other financial markets were stronger in civil law nations before World War I than after World War II. Upon examining the total value of the stock markets as a percentage of GDP, Mark J. Roe established that in 1913 several core civil law nations' stock markets — those of Belgium, France, Germany, and Sweden — were stronger than the stock markets of the United States. Between 1913 and 1970 stock market capitalization declined in most wealthy civil law nations while it increased in most wealthy common law nations. By 1970 the trend in the civil law nations seemed to reverse, thus stock market capitalization showed a general rising trend. By 1999 civil and common law nations again began to draw closer to each other in this respect. This historical change can hardly be explained by the La Porta theory, since in the past century there were significant changes in the economic systems of the individual states with the simultaneous constancy (and invariability) of legal families, therefore, the statements made in relation to the individual legal families are disputable from historical aspects. Roe strives to provide an explanation for the financial differences observed in developed western countries without using the legal origin theory. He considers that the key to the issue is that the 20th century history of wealthy common law countries significantly differed from the history of wealthy civil law countries. While the former were relatively spared from the most severe early-twentieth century destruction, the latter were not so fortunate. Postwar policies also differed in common law and civil law countries. Professor Roe emphasizes that political economy channels explain modern financial markets in the wealthy western countries at least to the same extent, or even more strongly than medieval legal origin theory. If legal origin was the reason for the differences in the financial results of the various countries, then its outcome should persist through time. However, if the consequences of modern wars, cataclysms and their consequences had a stronger effect on the developed countries and the financial markets, then their effects should have faded — and the professor can already observe evidence to this effect. Similarly, it is also a convincing argument as to the effects on ownership structures that in the case of countries where more than half of the medium sized publicly traded companies were widely held, all of these countries remained stable in the 20th century and none of them suffered military occupation, civil war, or violent revolution. Countries that had more concentrated ownership were exposed to more instability in the 20th century. The fact that Switzerland (a civil law nation) managed to preserve its extraordinarily strong securities market during the 20th century - presumably because

it was spared the destruction of the wars – also seems to support the significance of the effects of war devastation.

The cataclysms of the first half of the 20th century had a significantly stronger effect on the core civil law nations than the core common law countries, since the latter were more separated geographically from the conflicts. Between 1914 and 1945 significant destruction and instability was experienced in certain civil law countries which previously had relatively strong capital markets. According to professor Roe, the consequences were far from negligible. The major common law countries survived the events with their institutions left more or less intact, while the major civil law countries and their institutions suffered severe devastation, and they had to be rebuilt under the political circumstances following World War II, and the foregoing circumstances were not advantageous for the markets. In certain civil law countries the protection of labor markets was stronger and the allocation of capital was implemented by the state for the purpose of the rebuilding. Therefore, securities markets were shallower in these states at the end of the 20th century.

Moreover, according to professor Roe, following World War II the attitudes of average voters towards risks differed among nations in the wealthy West. Due to the differing degrees of wartime destruction and interwar inflation, capital holdings of the average citizen also differed. If the financial savings of a nation's middle class were devastated first by interwar hyperinflation and depression and then by wartime destruction of the underlying physical assets, it is possible that voters in such a nation would have cared little about protecting financial capital because they had little of it and because their well-being was tied more to their human capital.

Professor Roe also sets forth that the intensity of labor law (labor market) regulation predicts corporate ownership separation better than legal origin. From the foregoing he concludes that some nations, as a matter of policy and politics, support (supported) labor markets and ignore stock markets, presumably because labor interests dominate or influence their governments whereas finance-oriented property interests do not.

In Western Europe and East Asia (the legal system of which typically follows the civil law tradition) fighting communism gained significant importance following World War II. The nations forced to fight communism externally and internally would obviously adopt policies in relation to labor and capital markets different from those of nations that felt more secure. In these countries even right-wing politicians favored the adoption of measures that were advantageous for those social groups to whom the Communist Party could traditionally appeal. According to professor Roe, under the foregoing circumstances it is understandable that politics laid more emphasis on the regulation of the labor market and the protection of the labor force than on the capital markets. The above mentioned could have been the reason why after World War II the rich nations of the world pursued differing policies towards labor and capital markets. It could also have contributed to ownership concentration that in the second half of the 20th century civil law European countries established social democratic political systems. Social democratic systems give preference to the interests of other constituencies to those of shareholders. This may pressure corporate managers to subordinate shareholder interests, and only concentrated large shareholders can effectively compel managers to resist these pressures. Thus the strong power of employees to enforce their interests may influence the creation of a concentrated ownership structure. According to professor Roe's reasoning, in order to counterbalance significant employee influence capital needs to be concentrated. Employees participate in the management of the company for instance in Germany which has a strong civil law tra-

dition. Based on the above reasoning, concentrated ownership will be maintained in a corporate governance system where employees' influence is strong, concentrated ownership should persist, as concentrated owners counterbalance the strong employee influence. The foregoing also influences the development of equity markets, which develop less strongly.

Although professor Roe excluded the rich nations' former colonies in his explanation of the development of financial markets (thereby avoiding critical remarks), his approach fails to provide a comprehensive and universally applicable explanation for the phenomenon of ownership concentration. Hong-Kong is an adequate counterexample, where ownership concentration is extremely high, despite the lack of a social democracy or a pro-labor environment. John C. Coffee, professor at Columbia Law School criticized Roe's theory also on the basis that a government in a social democracy (such as Germany) cannot ignore the interest of such significant groups as shareholders. Secondly, Coffee questioned the historical foundation of the social democracy theory. According to his position, concentrated ownership was established in Germany and France well before the earliest appearance of a social-democratic government. In his opinion concentrated ownership was established in these countries by the late nineteenth century, therefore it preceded the appearance of social-democratic governments in these countries.

2.3. The theory emphasizing the importance of the autonomy of the private sector

Professor John C. Coffee disagrees with Roe's political economy-based explanation of ownership concentration. Nevertheless, his explanation for the appearance of dispersed ownership and liquid markets to some extent is itself based on political factors. According to Coffee, the governmental intervention either to protect the *Paris Bourse's* monopoly in France, or to favor the development of commercial banks in Germany created obstacles in developing dispersed and liquid stock market. In contrast, governments in the US and the UK took a more liberal approach to the private sectors and the stock market development. Based on such explanation, Coffee disagrees with Roe's position to the extent that social democracy is the key explanatory variable of ownership concentration. However, he does not reject the possibility that political factors may play important roles in shaping various ownership concentrations.

In relation to the development of stock markets and the appearance of dispersed ownership, instead of emphasizing legal regulations or the protection guaranteed by the legal system, professor Coffee considers more important the appearance of a private sector that is relatively free from direct governmental interference. Based on such approach, self-regulation and private self-help measures appear to have been the principal catalysts for the development of equity securities market in the US. Professor Coffee attributed the appearance of the earliest securities markets in the Netherlands (which is a civil law country) to a pluralistic, decentralized society in which the private sector was relatively autonomous and free from direct state intervention. This statement is to be given serious consideration by the state organs responsible for the economy of developing countries in relation to their reform endeavors. It is among the fundamental tasks to establish institutions of economic governance with sufficient independence, competence, and integrity to carry out effective enforcement.

Professor Coffee also emphasized that legislative action seems likely to follow, rather than precede, the appearance of securities markets, because a self-conscious

constituency of public investors must first arise before there will be political pressure for legislative reform that intrudes upon the market. Phrased differently, the legislature cannot anticipate and regulate issues that it has never seen.

The results of his study prompted professor Coffee to reinterpret the theory formulated by La Porta and his co-authors. According to his position, while markets can arise in the absence of a strong, mandatory legal framework, they neither function optimally nor develop to their potential in the absence of mandatory law that seeks to mitigate the risks of crashes. The professor considers that it cannot be clearly evidenced that strong legal rules encouraged the development of the leading stock exchanges of the world. However, he considers the reverse to be well-founded. Strong markets do create a demand for stronger legal rules. Consequently, law appears to be responding to changes in the market, not consciously leading it. From this perspective it can be argued that La Porta and his co-authors in fact considered the consequences to be the reasons. Strong legal rules are not the reasons for, but the consequences of highly developed markets.

2.4. Diverse corporate governance systems as the explanation for dispersed ownership and liquid markets

In order to draw conclusions on the structure of capital markets, it needs to be taken into consideration that in common law and civil law countries companies apply different models for corporate governance and allocation of power. In common law countries single tier governance is prevalent, where the board of directors has a decisive role. Numerous civil law countries (such as Germany) (traditionally) apply a two-tier governance system, which strictly separates the management and the control of the company, thus, the board of directors and the supervisory board, which indicates a different allocation of powers within the company. For instance, in the United States it is rather the board of directors and corporate managers that are in power, while in Germany (larger) shareholders possess more influence. At the same time, the corporate law of the State of Delaware provides a wide scope of authority to the board of directors (numerous possibilities for deviation from the principal rules) and contains few mandatory rules protecting shareholders. While, for instance German company law (and generally, European company law) offers few possibilities to deviate from the rules to the detriment of shareholders, thus it is typically of mandatory nature. At the same time (as we have previously mentioned) in the United States the board of directors has significant autonomy in delivering its decisions, while in Continental Europe (predominantly following the civil law tradition) the delivery of the most important decisions is subject to the approval of shareholders. Moreover, the US is strongly characterized by the entrenchment of the board of directors, while in Continental Europe directors can be replaced at any time by the majority of shareholders' votes. Thus shareholders have significant control over the delivery of important corporate decisions. Thus, in Continental Europe, the stable situation is one in which the board and the majority shareholder cooperate extensively. Whereas in the United States, a majority stake does not impart significant control over the company, since the board of directors can decide on a wide range of questions without consulting the shareholders. Therefore, in the United States the acquisition or maintaining of a majority stake does not outweigh the costs that such a stake would entail, as it does not impart significant control over the company. This phenomenon can be adequately presented by way of an example. The group of founders of a company, or possibly the venture

capital investors appearing at a later stage, sooner or later transforms successful and growing companies into public limited companies, for the purpose of raising capital (or selling the company). However, the original owners typically strive to retain control over the company. Since in the United States the board of directors holds the most significant decision making powers, it can control the company through such powers. If the founders and their confidants hold the board positions, they can deliver practically all decisions regarding the ordinary course of business of the company, even without the support of the general meeting. Opposing proposals by shareholders face significant difficulties due to the *collective action problem* and costs of small shareholders. Moreover, US boards can entrench themselves, thus in practice they are less exposed to removal. This circumstance is favorable for the development of dispersed ownership, as the original owners of the company do not need to hold large stakes in order to retain control over the company. Whereas in Continental Europe shareholders exercise strong decision making rights in companies (thus the board of directors is to surrender to shareholders in relation to numerous, frequently occurring issues), and directors can be replaced any time. Therefore, the retaining of a significant stake confers strong control over the company; while on the other hand, the holding of director positions does not in itself provide a guarantee to original owners for retaining control over the company. Consequently, the original owners of the company tend to retain significant stakes, share blocks, since in lack of such stakes another shareholder group can easily acquire control over the company. However, the retaining of significant stakes, due to the significant control imparted thereby, counterbalances the costs that such stakes would entail. Thus, in Continental Europe original owners do not reduce their stakes to an extent resulting in the development of dispersed ownership. Thus, the allocation of competencies within the company may influence ownership structure. In the course of time those holding advantageous positions (the board of directors in the United States and in common law countries, blockholders in Continental Europe), by lobbying the legislature, may further strengthen the position held thereby as a result of the allocation of powers.

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