

The Rule of Law: Good for the Economy?

READING GIVEN AT BARNARD'S INN

BY MASTER PROFESSOR SIR ROSS CRANSTON FBA

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The following is an abridged version of the Reading. The full text is available online.

In one of his many outstanding contributions to the history of modern Germany, the Provost of Gresham College recalls the important role Max Weber's thought played for post-war West German historians. In *Wirtschaft und Gesellschaft*, written in the early 20th century, one of Weber's themes was the mutual interdependence of the rational methods and institutions of modern Western law and the West's economic development.

But how then did he account for capitalist development in Britain against the backdrop of the non-rational maze of the common law? In a number of short and contradictory passages, Weber attempted to maintain his thesis with two main arguments: first, the unhelpfully vague assertion that English judges were active in the service of capitalistic, private interests, and, secondly, the positive, economic effects of the administration of justice being concentrated at the central courts in London to the exclusion of non-propertied interests. If the second point had been further developed, Weber could have explained how English contract law was forged largely in the context of shipping, insurance and other commercial disputes, rather than in litigation about tenancies and consumer transactions.

Jumping to the end of the last century, possibly the most famous article in the field of finance was 'Legal Determinants of External Finance'. Unlike Weber's quiet contemplation of the law/economy relationship, this, and the subsequent 'legal origins' literature, encompassed number-crunching on a grand scale to identify correlations. In the initial 1997 study, data was gathered from 49 countries to match the standard of

investor protection, measured by the character of legal rules and the quality of law enforcement, to the development of the capital markets. A further article in 1998, with data from the same 49 countries, found that common law countries generally had the strongest, and French civil law countries the weakest, legal protections for investors, with German and Scandinavian civil law countries located in the middle. Reviewing the literature in 2013, three of the original authors reached a number of conclusions: in brief overview, that differences in legal rules matter for economic and social outcomes, with the market-supporting solutions of the common law system working better than the policy-implementing solutions of the civil law system as far as positive economic consequences are concerned.

The conclusions of the legal origins school have been contested: in particular the conclusion that common law countries are more conducive to economic and financial development than those in other legal families. Criticisms have been made about the methodology of the studies and that the common/civil law division is too simplistic. It is said that its overall conclusions are belied by Asian developments. Best exemplified by China is a model where economic boom has occurred in the absence of many rule of law features, certainly as we understand them. By contrast, in common law India the judiciary has not played a significant role in adapting the substantive law to the changed needs of a market economy.

For several decades the World Bank has advanced the link between the rule of law and economic progress in its prescriptions for developing and emerging economies. 'Justice and the rule of law', it states on its website, 'are central to [the Bank's] core agenda of ending extreme poverty and promoting shared prosperity.' The World Bank's working definition of the rule of law entails accountable officials; laws which are clear, available, stable and protective of human rights, the efficient and fair enactment and application of those laws; and the administration of justice by competent, ethical and independent officials. In its 2017 World Development Report the Bank sought to gather together its accumulated wisdom on the subject and its wider point about the positive impact of good governance. The report and its accompanying appendices drew on the Bank's extensive experience in many countries to support its conclusion that the rule of law is needed for a country to realise its full social and economic potential.

My exploration of the link between law and economic development

is not Weber's library contemplation, the number-crunching of the legal origins school and its critics, or the World Bank's inferences drawn from disparate case studies of experiences in developing and emerging economies. What I seek to do is to draw inferences from the history of English commercial law and development since the first part of the 19th century. In broad outline, I examine transactional law – markets, agency, sales, financing, and dispute resolution – and, by delving into business and banking archives, seek to explain whether the law was supportive of commercial activities and was perceived as responsive by the commercial community. In this lecture I hope to give a flavour of the larger study. I begin with how English judges in their law-making have consciously attempted to facilitate commercial activity.

Three, key philosophical underpinnings of English commercial law

The first is freedom of contract. The rapid development in contract doctrine to accommodate the changing economy in 19th century England was the subject of Professor Patrick Atiyah's magisterial account, *The Rise and Fall of Freedom of Contract*. Atiyah's story is of the replacement after 1800 of notions of fairness and equality of exchange, coupled with liability based on reliance or the receipt of benefit, by notions of contract based on the expressed will of the parties, and liability grounded on promises (offer and acceptance and the intention of the parties). Whether the transformation is as stark as Atiyah suggests, there can be little doubt that, as he contends, 19th-century contract law 'was closely related to the ideas of the political economists and to the rise of the market economy'.

Atiyah was writing in the 1970s, and just as his 19th century judges were influenced by the political economy of their time, so his 'fall' in freedom of contract was associated with what he saw around him: the rise of the mixed economy, the corporatism of the 1970s and the intrusion into free contracting of legislation such as the Consumer Credit Act 1974. In fact the history in the commercial sphere continued to be one of few limitations being placed on how parties might contract and of the courts upholding bargains struck. As Lord Collins JSC put it in *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* [2011] UKSC 38, 'despite statutory inroads, party autonomy is at the heart of English commercial law ... it is desirable that, so far as possible,

the courts give effect to contractual terms which parties have agreed. And there is a particularly strong case for autonomy in cases of complex financial instruments ...'

The second philosophical underpinning of English commercial law is certainty. That has sometimes been so emphatically stated as the touchstone for decision-making that outcome is secondary. This can be traced back to Lord Mansfield, who said in 1774: 'In all mercantile transactions the great object should be certainty and therefore it's of more consequence that a rule should be certain, than whether the rule is established one way or the other. Because speculators in trade then know what ground to go upon.' One of the greatest of Gray's Inn's members in recent times, Lord Bingham, quoted this passage in his dissent in *The Starsin* [2003] UKHL 12, adding that 'this observation is ... particularly pertinent where the issue is one which ... has been the subject of repeated litigation over the years.'

Thirdly, English commercial law keeps equitable doctrines at bay. For present purposes, equity can be taken as the rules applied in the Chancery courts. Some of these, such as undue influence, unconscionability and relief against forfeiture, are directed at fair dealing. Another of Gray's Inn's great 20th century judges, Lord Atkin, said in *Re Wait* [1927] 1 Ch 606: 'It would have been futile in a code intended for commercial men' – the Sale of Goods Act 1894 – '... [if] at the same time it was intended to leave, subsisting with the legal rights, equitable rights inconsistent with, more extensive, and coming into existence earlier than the rights so carefully set out in the various sections of the code.'

An illustration of the attitude of English commercial law to equitable doctrines is provided by *The Scaptrade* [1983] 2 AC 694, where four days after a charterer had failed to pay the monthly hire in advance, as required by the time charter, the owners withdrew the vessel. They were able to do this under a clause in the charterparty. It was a time of rising freight rates and they could re-charter the vessel at a profit. The House of Lords held that the charterer was not entitled to relief from forfeiture notwithstanding the argument that the strict application of the withdrawal clause led to capriciousness. The possibility that shipowners might snatch at the opportunity to withdraw ships from the service of time charterers for non-payment of hire was well known in the world of shipping, as was the possibility of inserting an anti-technicality clause to prevent such an occurrence.

So freedom of contract, the need for certainty for commercial

contracting, and confining equity's reach are three of the key underlying principles of English commercial law. Each is based expressly on the perceived needs of the commercial community. Each is regarded as essential if markets are to operate smoothly and efficiently, and commercial parties are to achieve their aims.

Five examples where 19th and 20th century infrastructure contributed to commercial and financial innovation

The first example is the Bankers' Clearing House, which facilitated payment by establishing a central payment system for the exchange and settlement of bills of exchange and cheques. Cheques were introduced in the 18th century; bills of exchange have a much longer pedigree. In 1770 a clearing system for bills of exchange and cheques was formalised in the City of London. Initially clerks from the different private banks met at the Five Bells, a tavern in Lombard Street. The first clearing house was built in Lombard Street in 1833, initially with bilateral netting but, from 1841, multilateral netting. In 1854 settlement in cash was replaced by settlement across the accounts the banks held at the Bank of England. The important role it has played in the payment system has continued ever since. In 1854 James Grant, in his *The Law Relating to Bankers and Banking*, described the clearing house as follows:

'The Clearing House is a large room fitted with drawers: each banker, using the house, has one of these, marked with his name or firm. In the morning, and at half-past three o'clock in the afternoon of each week day, a clerk from each banker using the house attends, bringing with him the cheques on other banks that have been paid into his bank since last clearing; these he deposits in the drawers of the respective banks on which they are drawn; he then credits their accounts separately, with the different amounts of the cheques they have placed in his drawer, as against his bank.'

The clearing house circumvented the need for the banks to send their clerks with the bills of exchange and cheques their customers had deposited with them to the other banks where these were payable or on which they were drawn. Instead they could collect the moneys owed their customers by presenting bills and cheques centrally at the clearing house. As a result of the netting of payment obligations between the

banks, clearing reduced the amount of money a bank needed to have ready to settle its debts.

The courts quickly became familiar with the operation of the clearing house. As early as 1811 Lord Ellenborough held that presenting a bill of exchange through the clearing house was sufficient, although the acceptance on it indicated that it would be paid at the bank's address in the City of London. The Court of Common Pleas held in 1843 that acting in accordance with the practices of a clearing house was the reasonable course for bankers to take, and one the law would protect. By the end of the 19th century the courts were giving effect to the rules of the clearing house in pinning liability on a bank failing to comply with them. The only potential defect in the clearing system, identified by the prominent economic commentator Ernest Seyd, was if one of the banks collapsed: he thought this unlikely, since there was careful vetting of members. In any event, should it occur, the understanding was that all its payments in the clearing would be unwound. 'Our Law Courts would uphold this understanding as a "banking law" established by custom', he confidently asserted.

A second example of the courts endorsing the workings of the City of London's infrastructure concerns the London discount houses, the basis of the money market. This requires an understanding of the centrality of the so-called 'Bill on London' in financing international trade. The merchant banks (the acceptance houses) accepted (in the legal sense) bills of exchange drawn, for example, in favour of British exporters, but then sold (discounted) them in the market. Discounting meant that the exporter (in our case) received immediate payment for its goods before the 60 or 90 days when payment under the bill was due, but not out of the bank's own funds. Payment was at a discount to the face value to take into account the early payment.

Although in law the acceptance house was primarily liable on the bill, having accepted it, the exporter was paid because the bill was sold. The bill brokers who discounted bills in the first part of the 19th century became discount houses later in the century, funding themselves by short-term deposits from the banks (with whom they did not compete), and selling (rediscounting) bills on their own account to the commercial banks and the Bank of England. Later the discount houses also bought government bonds, and with time that became the avenue for conducting monetary policy. London thus developed as the world's first money market in short term monetary assets.

The law provided no obstacles to the discount of bills of exchange. Onward sale was part of the fabric of bills of exchange law from the 18th century, with refined provisions for the endorsement of bills and its hierarchy of liability in the event of the failure of any one party to a bill to pay. But the discount market in London came into sharp focus with the collapse of the largest discount house, Overend Gurney & Co Ltd, in May 1864. What led to the immediate crisis was a judgment on 8th May 1866, which held that Overend Gurney (and others) could not sue the acceptor of the bills of exchange they held because the bills were *ultra vires* the issuer. (That has resonance with *Hazell v Hammersmith and Fulham LBC* [1992] 2 AC 1 and the cases which followed, where the courts held that derivative contracts are void as being *ultra vires* a local or public authority's powers.)

Following the judgment there was a run on Overend Gurney, and on 9th May it applied to the Bank of England for assistance. The Bank of England refused to provide liquidity on the ground that it was insolvent. Despite its prominence and position in the market, it was not too big to fail. Mid-afternoon on 10th May 1866 Overend Gurney suspended payment. Panic ensued. The Bank of England used its reserves to support the banks and the other discount houses with liquidity through bill purchases and repurchase agreements for government debt. The banks and discount houses could thus meet demands by depositors, including in the case of the discount houses the commercial banks which, as I have said, deposited funds with them. Confidence was restored, although some 200 companies and banks failed in the aftermath.

What came out of the Overend Gurney crisis was the publication in 1873 by Walter Bagehot, then editor of *The Economist*, of his famous *Lombard Street, A Description of the Money Market*. The book advanced the case that to prevent systemic failures in similar panics the Bank of England should act as the lender of last resort. That has become a fundamental principle of central banking. What also came out in the wash in Overend Gurney's liquidation were its slack and risky practices in bill discounting and other ventures. But the practices of the London money market emerged unscathed. In *Re Fox, Walker, & Co* (1880) 15 Ch D 400 the court recognised the almost invariable practice of bill brokers in the London market not to endorse the bills they discounted, but to give a general guarantee for all bills discounted.

My third example of law supporting financial infrastructure concerns the growth of the futures markets. As with my first two examples, the

courts performed a legitimising role, in this case enforcing the rules of the commodities exchanges and clearing houses as regards, for example, margin payments, but also shielding futures dealings from the gaming laws.

My fourth and fifth examples are directed at commercial techniques rather than institutions. These days asset finance involves finance leasing, hire purchase, and sale and leaseback. Finance leasing is used for businesses needing equipment, whether it be photocopiers, fork-lift trucks, manufacturing plant, motor vehicles or aircraft. The finance house or bank purchases the equipment and leases it to the business for a period, the business paying the full value of the equipment, plus interest, over the period of the lease. One obvious advantage is that a business gains access to the equipment without incurring the immediate cost of an outright purchase.

Hire purchase takes matters one step further and allows the business to buy the equipment on credit: the equipment is leased (or hired) and at the end of a specified period the business can exercise an option to purchase it, usually for a nominal sum. A sale and leaseback transaction performs the different function of enabling a business to raise money on the back of its existing assets. The business sells assets to the finance company or bank, which then leases them back to the seller-lessee under a finance lease or a hire purchase agreement.

The finance lease developed in England in the mid-19th century with railway wagons. Because of the amount of capital required and the fluctuating demand, the railway companies decided not to purchase wagons themselves but to leave it in the main to those wanting to transport goods to furnish their own wagons. From the point of view of businesses needing wagons, the advantage of hiring them was that they need not lay out capital immediately for their acquisition. When coupled with a sale of wagons under what was called deferred purchase terms, later known as hire purchase, businesses obtained their wagons on credit. Deferred purchase was especially attractive to less well capitalised companies such as smaller collieries.

There were legal risks for the wagon companies, which reached the courts in the late 19th century. The first concerned the distinction between conditional sale and deferred (or hire) purchase. If the lease of wagons with the option to purchase was in reality a credit or conditional sale, the wagon companies might not have a property claim in the event of a hirer's insolvency. It might also be that a hirer could give good title

to a third party under the Factors Acts. This was not a major risk when wagons had the name-plates of the wagon company attached. However, it did arise in other contexts, since deferred or hire purchase was used increasingly from the 1860s for the sale of pianos, furniture, and sewing machines to members of the middle and skilled working classes. After a slight hiccup, the courts helpfully characterised hire purchase not as sale, but as hire, coupled with an option, albeit not an obligation, to purchase: *Helby v Matthews* [1895] AC 471.

In commercial circles, however, a second risk loomed larger. That was with sale and leaseback, where a business sold its wagons to raise money and then leased them back for continued use. The issue arose in 1886 in what was recognised as a test case: *North Central Wagon Co v Manchester, Sheffield and Lincolnshire Railway*. The judge at first instance held that the documents between North Central Wagon Co and the colliery constituted an unregistered bill of sale so that the sale and leaseback was void. That finding was reversed on appeal. In the 20th century a number of the wagon companies became finance houses, offering hire purchase and finance leases.

My final example concerns the Euromarkets, which developed in London from the 1960s. The story has been told a number of times, including in Niall Ferguson's excellent biography of Siegmund Warburg, *High Financier*. Essentially, there was a surplus of dollars outside the United States and the City of London became the centre for their deposit and recycling. New York might have assumed that role but the US Interest Equalisation Tax and Regulation Q discouraged it. In Ferguson's account, the development of the Eurobond market was 'a largely spontaneous result of innovation by private sector actors, with some help from Britain's permissive monetary authorities'. Warburg's insight was that a syndicate of banks 'could, under the right regulatory conditions, operate across European borders without violating existing rules on exchange and capital controls, not least because the loans were denominated in dollars'.

The first Eurobond issue was in 1963 for \$15 million for the Italian Autostrade. The bonds were 5½%, 1972/78, guaranteed by an Italian state entity under the management of Warburgs, Deutsche Bank, Banque de Bruxelles and Rotterdamsche Bank. They were quoted on the Luxembourg stock exchange. The solicitors were Allen & Overy, who had to overcome a number of legal issues such as the UK controls on capital issues and the registration requirements under the UK

companies legislation for bonds being offered to the public. When the Eurodollar market was finally considered by the courts some 25 years later, its insulation from US controls was upheld in *Libyan Arab Foreign Bank v Bankers Trust Co* [1989] QB 728.

What we can draw from these examples in terms of the larger topic: the relationship of law and economy

One feature was that English commercial law enabled commercial and financial institutions and associations to draw their rules and standard contracts to their own design. Freedom of contract was not the answer to every problem: it was not possible to overcome the ultra vires rule through contractual provisions. But in many cases freedom of contract enabled the commercial community to draft around a problem. In *Cooke v Eshelby* in 1887, the House of Lords applied ordinary agency principles to dealings between brokers on the Liverpool Cotton Exchange. That caused consternation, but the problem was solved by the market redrafting the contract.

I should highlight some features of this private law-making. First, it was often innovative in addressing commercial need; secondly, it was generally by the trade itself so that lawyers were only occasionally involved; and, thirdly, dispute resolution was informal, with arbitration by members of the relevant trade association.

Another feature of the relationship of law and economy was that commercial practices took on the force of law. The simplest illustration of that was that commercial custom (trade usage), if well known, certain and reasonable, could be used to interpret commercial contracts and to add terms. Particular ports and markets were not infrequently held to be the repository of such customs and usages.

A further aspect of this second point is what Professor Sir Roy Goode has described as market practice being able ‘to pull itself up by its own legal bootstraps’. This is not so much an application of the rule about commercial custom and usage, but more the point I made earlier about the courts legitimising an institution, market or commercial way of dealing.

That leads to a third feature of the relationship: that English judges have generally been supportive of commerce and have attempted to reach commercially helpful results. Thus the House of Lords abandoned

the breach date conversion rule in the *Miliangos* case in 1976 and Lord Denning facilitated the *Mareva* injunction. Of course, there will sometimes be disagreement between judges as to what, for example, is the commercially sensible interpretation of a contract.

In conclusion, the history of English commercial law over the last 200 years lends some support to the link between the law and economic progress. The banks, the commodities and financial markets, Lloyd's insurance, the Baltic Exchange and so on were all able to function against the backdrop of a generally favourable and supportive law and a legal profession on tap to smooth the wrinkles. We have encountered various examples of commercial innovation, generally given the stamp of legal approval. If not, there was the ready ability to return to the favoured position through free contracting. Institutionally the Commercial Court was designed to provide an expert forum for the settlement of commercial disputes, and that attempt to accommodate commercial needs continues to the present with, for example, the creation of the Financial List in 2015.



Barnard's Inn Hall