

# Privatizing Commercial Law

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**W**E ALL KNOW THAT LAW IS expensive. Do we know why? There has been strikingly little study of this question, but one important factor is the monopoly that government holds over coercive dispute resolution. Though conflicting parties can work out their differences on their own or with the help of privately provided negotiators and arbitrators, only government and the courts can use coercion to enforce contractual commitments or settle other disputes.

The state's monopoly over legitimate coercive power is not, in itself, problematic; this monopoly is definitional of the state. The problem lies in the state's monopoly over the rules and procedures governing the application of coercion. Not only does the state enforce a contract, it designs and administers contract law and procedure. And it does so with all the drawbacks of an insulated service provider: unresponsive to costs, reluctant to innovate, bureaucratic in its methods of collecting and processing information, shut off from entrepreneurial creativity and effort. These drawbacks contribute to the high cost of law.

It does not have to be this way. History offers many examples of legal regimes that were designed and administered by private entities. These examples do not give us off-the-shelf models that we can immediately implement in the modern economy, but they do offer insight into how we might develop competitive, private legal regimes suitable to the economy of today. Democratic legitimacy does impose limits on the extent to which we can use private legal regimes to direct the state's coercive powers. But the state can legitimately delegate significant areas of the law to private entities, especially the areas governing relationships between corporate entities. Privatizing commercial law is not a simple task, but it is one we can, and

should, explore. Doing so holds the promise of significantly decreasing the cost of law.

## THE ECONOMIC AND JUSTICE FUNCTIONS OF LAW

LEGAL SYSTEMS IN MODERN DEMOCRACIES PERFORM many functions. They oversee the institutions of democratic governance, administer the modern welfare state, protect individual rights, ensure social order, and provide a means of non-violent dispute resolution among citizens. These are what we can refer to as the "justice" functions of the legal system. Because the justice sphere of the legal system involves the rights and obligations of citizens, it must be delivered by the state for reasons of democratic legitimacy. For a state to be democratic, its citizens must have recourse to the politically accountable institutions of the state for the vindication of their rights and the management of their relationships vis-à-vis their fellow citizens and the state itself.

But the legal system also performs important economic functions such as providing the structure and regulation necessary for the operation of efficient markets. The economic sphere of law regularly deals with relationships that involve only corporate entities. Private legal regimes could provide this law without raising legitimacy concerns.

The rules we want in these interactions are the rules that promote and facilitate efficient market relationships between corporations. In this setting, we are not interested in what is fair or just between two corporations; we are interested in what makes their economic relationship as productive and valuable as possible. That goal suggests the need to look for ways to increase the role of markets in the process of developing and administering the legal regimes that govern the relationships between corporate entities.

## HOW WOULD IT WORK?

SUPPOSE WE WERE TO PRIVATIZE THE PROVISION OF law for corporate relationships. How would this legal system differ from what we have today? As things stand now,

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corporations can design almost all of the elements of their contractual relationships. They can even choose to have their disputes adjudicated in private arbitration systems, according to procedures designed by private arbitrators.

There are significant private elements in these aspects of modern contract law. These private elements are, however, in the shadow of the laws of contract — arbitration, evidence, and civil procedure as designed and administered by the state. The reason lawyers play an expensive role in the drafting of contracts and arbitration clauses, and in the litigation over contract disputes, is because they have expertise in the legal rules, reasoning, norms, and procedures of the state. Legal advice on contract drafting, for example, gives contracting parties information about how the public courts will interpret and apply contract language. “Private” contract and arbitration, under our current regime, depend heavily on the law developed and administered by the state courts.

The only “competition” (i.e. pressure for innovation or cost reduction) affecting the development of such law comes from “competition” among courts in different jurisdictions or from political “competition” in the form of lobbying for statutory change. This form of competition is particularly evident in the area of corporate charters, where it is common to speak of competition among state legislatures for the revenues that will flow from offering attractive terms. We could say that Delaware courts and legislators “compete” with Nevada and Pennsylvania for the business of incorporation.

It is a mistake, however, to equate competition among political bodies or courts with competition among profit-maximizing firms. Politicians and bureaucrats do not evaluate and pursue innovations in law in the way that entrepreneurs do—with the speed, flexibility, resources, and incentives of the market at their disposal. It is the latter form of competition that holds the promise of facilitating entrepreneurship and innovation in legal regimes to cut costs and improve efficiency.

In a world of truly competitive privatized corporate contract law, contracting parties would face a marketplace of alternative regimes. Private firms would design packages of substantive and procedural law that would govern the interpretation and enforcement of corporate contracts. A hypothetical firm SimpleContracts Inc., for example, could offer a regime in which contracts were limited to the use of plain language, with a rule of strict interpretation, minimal procedure, and a guarantee of a decision within two weeks of a complaint. The use of lawyers could be restricted, or SimpleContracts could provide the services of professionals trained to meet the goal of reducing contract enforcement costs.

If the market demands more complex interpretive approaches or more extensive procedure and discovery,

CarefulContracts Inc. could offer that package. PreventiveContracting Inc. could market a package that includes early warning dispute resolution to reduce the incidence of contractual breakdown and the need for contract adjudication. OldReliable Inc. could offer the current law and procedure of the Uniform Commercial Code, replete with full-scale discovery, lawyers, and traditional adjudication.

The key virtue of a competitive commercial law regime is that these offerings would succeed or fail based on the extent to which they met the needs of the market, and the extent to which the value of their products justified their cost. Entrepreneurs who identify innovations that better meet the needs or reduce the costs of contracting would face an incentive to bring these innovations to market. This is not true of the world of commercial contract law that we have today. It is not even true of the world of commercial arbitration, where competition is limited to the procedural ele-

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ments of the package and the state’s legal regime casts a long shadow. A truly competitive private legal regime is one in which entities design and implement the substantive and the procedural rules with an eye to market incentives, market rewards, and market penalties.

### A HISTORY OF PRIVATE LAW

IF THE IDEA OF COMPETITIVE PRIVATE LEGAL REGIMES sounds other-worldly, then we have forgotten our history and have not noticed some features of our present. From the Middle Ages to the infant digital age, there are examples of law developed and administered by private entities with varying degrees of state involvement.

**Medieval merchants** Commercial law has its origins in a purely private regime: the merchant guilds of medieval Europe. *Lex mercatoria* — the law governing the relationships between commercial traders — was a privately designed and administered system that was made effective by the power of the sovereign to coerce compliance.

This system emerged in response to a fundamental problem of economic relationships: how to secure the commitment of trading partners in order to make rational the decision to entrust goods or payment to others removed in time and space. The development of long-distance trade in the medieval period required local merchants to trust agents to carry their goods to distant lands and return with the prof-

its. The development of credit relationships required merchants to trust other merchants to make good on promises of payment or delivery. Enforcement mechanisms such as reputation and community sanction worked well in highly localized communities and trades, but those mechanisms could not rise to the task when trade took place over long distances and periods of time.

Medieval merchants solved this problem by creating a system of rules and procedures that extended the power of

all accept a system of rules governing contract interpretation and enforcement among themselves. Here, compliance with the law comes from two sources: the power of the association to exclude a noncompliant member, and the power of the state to enforce the association's membership contract.

Unlike the state law of contract, these regimes often adopt simple rules and strict rules of interpretation. When the application of a rule appears to identify a loophole, adjudication is based nonetheless on the strict application

of the rule. In some cases, the beneficiary of the loophole publicizes this fact to the other members of the association, thus incurring a reputation penalty; in others, the association reviews the rule in question to determine whether it needs to be amended. In deciding whether or not to close the loophole, the association presumably takes into account how costly this particular gap is to traders, how likely it is to arise in the future, and how effective the reputa-

tion penalty will be in deterring opportunists from taking advantage of the simple rule.

This represents an important set of differences from the way in which the state common law responds to the inevitable gaps between the letter and the spirit of rules. Under common law processes, the gap is addressed through interpretation. In the context of the adjudication, a gloss on the rule is developed to match the rule as expressed in the common law (whether it is of common law or statutory origin) with the intent of the rule. This means that the would-be opportunist does not get away with the benefits of the loophole. But it also means that the law, by its own logic, becomes more complex, without a broader assessment of the costs and benefits of the increased complexity. And, of course, there is no ability for the courts to draw on reputation penalties as an alternative to a costly increase in the complexity of the legal standard.

Common law develops in a case-by-case way that generates increasing complexity and subtlety in the rules governing commercial relationships. The private systems developed by the trade associations represent a potentially valuable innovation that we cannot expect to emerge in the public system, at least not under the cost-benefit test of the market.

**Securities exchanges** Stock exchanges have long required members to accept a legal regime governing trades. Prior to the 1930s and the enactment of the securities and exchanges acts, these regimes were almost wholly private, coming into contact with public law largely through the membership contract. Today, these regimes are under the scrutiny of the Securities and Exchange Commission (SEC) and courts enforcing the securities laws. SEC rules govern not only the structure of the exchange, they also oversee the elements of the legal regime offered by the exchange. This is a very substantial public element. Nonetheless, there is

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a local community — the merchants of Genoa or the Maghribi traders for example — over a larger population. This “merchant law,” of varying degrees of formality, set the standards by which the conduct of participants could be judged. Enforcement came by way of exclusion; agents who failed to deliver the goods or rulers who failed to compel compliance with credit obligations or to protect the property of foreign merchants were denied access to the trading community, its goods, and profits. Local rulers backed the authority of the guilds to determine who could and who could not engage in trade.

Over time, the merchant guilds were opened up to competition and the creation and administration of commercial law became a function of emerging nation states. We clearly do not want a return to the merchant guilds of yore, but we should consider one of the lessons they taught: the power to coerce compliance with a legal regime can be decoupled from the function of designing and administering the system according to which that power will be exercised. The medieval merchants possessed the knowledge and the flexibility to design a set of commercially sensible rules that supported trading relationships and expanded the scope of trade. But the merchants, by themselves, did not have sufficient power to put these rules into effect beyond the limits of local communities and local reputation. Local rulers possessed the power to enforce, but not the knowledge (or, perhaps, the inclination) to develop the rules governing the use of their power in the service of expanded trade. The solution that presented itself — for merchants to design and sovereigns to enforce the law — is one that we would do well to reexamine.

**Trade associations** Since at least the nineteenth century, certain trade associations have tied membership to the acceptance of a legal regime designed and administered by the association. Diamond merchants, feed and grain sellers, etc.,

scope for competition among exchanges, and now among alternative trading systems such as NASDAQ and e-Trade. Traders who choose between alternative trading systems must evaluate not only the cost of the trade, but also the efficacy of the rules supporting the trade. These rules can vary, albeit within a limited scope as allowed by the SEC, from system to system, in response to market incentives.

### GUIDELINES FOR PRIVATIZATION

THESE EXAMPLES OF PRIVATE AND QUASI-PRIVATE legal regimes suggest several principles that can guide the effort to increase the role for competitive markets in the design and delivery of commercial law.

**Value of Commitment** The function of law in commercial relationships is to provide the commitment necessary to support cooperative economic activity. Contracts, corporate charters, and financing arrangements all depend on mutual commitments. The power to commit is the power to enter into economic relationships that are not limited to local communities or spot transactions. The value of commitment is the value associated with the economic activity it supports.

**Sources of Commitment** Law provides a means, but not the only means, of securing commitment between commercial actors. Commitment can be secured through a number of mechanisms and, importantly, mechanisms can be combined to achieve an optimal commitment regime.

**Reputation** Reputation mechanisms operate by altering the incentives of potential trading partners to engage in economic activity with the holder of a reputation. This, in turn, alters the incentives of the reputation holder to cheat or comply with its commitments. Reputation mechanisms can be entirely informal and social. Or, as was true in the medieval guilds, they can become harnessed to a more structured regime of information gathering and dissemination. Their power can be more fully developed when those who enforce the reputation penalties are, themselves, subject to a penalty for failing to cooperate in the boycott of a cheater. At this point, law may come in to support (but not displace) the reputation commitment device.

**Technology** Commitment can also be secured through the use of technology. The Internet presents us with fresh opportunities for innovative solutions. Encryption products provide a means of commitment with respect to the security of information transfers and the delegation of such powers as the entering of charges against a credit line. The company VeriSign Inc., for example, bundles encryption technology with a secure system for verifying that a website displaying the VeriSign symbol is in fact using the technology.

Companies are also using technology to structure innovative means of commitment in commercial negotiations.

Algorithms that allow negotiating parties to enter their bids without revealing them (such as the service offered by clickNsettle.com) use the technology of computers and the Internet to commit negotiators to a trade in the event that their bids come within a designated range of each other. Other hands-tying techniques include automated payment orders executed by a program that does not allow orders to be revoked, or systems that automate widespread E-mail notification of price changes or failures to comply with quality assurances. Again, we can see how one mechanism — technology — can combine with other mechanisms — law, reputation — to achieve commitment in commercial relationships.

**Organization** Commitment is ultimately about the divergence in incentives that can emerge over time. What appeals to corporate profit-maximizing incentives at the time a deal is entered into can, and generally does, diverge from what is profit-maximizing ex post. A promise of high quality is valuable up front because it induces trade; a delivery of low quality is valuable ex post once the trade has been secured and costs can thereby be reduced. Commitment mechanisms are an attempt to overcome the change in incentives that emerges over time. Reputation and law, operating directly on the incentives of the entity that made the original commitment, attach penalties to cheating. Technology changes the environment and the potential scope for cheating.

Organizational commitment arises when tasks are delegated to a different entity in an irrevocable manner. Again, developments on the Internet provide us with interesting examples. Individual e-businesses face the problem of how

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to commit to assurances of quality, security, systems integrity, and so on, in their transactions with other organizations. One of the ways in which they are achieving commitment is to submit themselves to the oversight of another business entity that takes on the role of ensuring that commitments are kept. Seal programs, such as the one administered by CPA WebTrust, change the organizational structure of the transaction. Under these programs, individual e-businesses seek an audit from a provider such as WebTrust and commit themselves to complying with the terms and conditions associated with the seal. This shifts the commitment problem from the corporate customer to the seal provider. The provider, in turn, faces an incentive to ensure

compliance because the value of its service depends on its ability to do so. This organizational mechanism transforms the commitment problem and, in doing so, may reduce the cost of commitment.

Again, we can see how this can operate in combination with reputational, technological, and legal means of securing commitment. Seal providers face reputation penalties for failure to do their job and they can make use of technological and legal means of ensuring compliance with seal requirements. CPA WebTrust, for example, packages its auditing service with VeriSign's encryption verification

complexity is worth the increase in the accuracy with which the rule is applied. Common law reasoning provides no mechanism for making this assessment; in fact, common law reasoning attaches an unlimited value to increases in accuracy, and permits unlimited increases in complexity. Judges cannot deny litigants the right to introduce relevant evidence or to make relevant arguments, even when the cost and effort associated with hearing the evidence or arguments far exceed any conceivable incremental effect on the outcome in the case.

It is possible for lawmakers to design statutes with these considerations in mind, but it is generally the case that, once the statute becomes subject to common law interpretation and application in the courts, it is vulnerable to the same entropic forces towards complexity as a judge-made rule.

Another reason the public legal system cannot achieve an optimal legal design is because optimal legal rule is a function of the mix of available commitment mechanisms. In the absence of low-cost encryption

technology, for example, an optimal legal rule to provide the commitment necessary to ensure security of e-commerce transactions may require establishing detailed standards for the handling of sensitive data. When technology changes, the optimal legal rule may be a much simpler rule requiring only the enforcement of the contract between an e-business and an encryption verification system. The public legal system lacks the means, resources, and incentives to monitor and respond efficiently to these changes in the cost-benefit environment in which commercial commitment problems are situated.

Competition among decentralized private law providers, on the other hand, creates the incentives necessary for market actors to design and protect systems that accurately balance the cost of legal rules with their benefits. Private competition also creates the incentive for market actors to monitor changes in the commitment environment and to exploit the potential for cost reduction arising from a shift in the mix of commitment mechanisms used by commercial actors. These are complex problems for public institutions but they are routine problems for market institutions and entrepreneurs. Privatizing commercial law would harness the benefits of decentralized information processing and problem-solving, and bring it to bear on the problem of legal design.

**Legitimacy** The benefits of competition among private law providers might appear sufficiently attractive that one might wonder why we should have public courts involved at all. It is important to remember that privatization is justifiable only for those areas of law in which efficiency is the only value at stake. By and large, those are the areas of law in which we are concerned with the commercial relationship between

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service and administers a legal regime consisting of a Certification Practices Statement (CPS) and dispute resolution procedures for failure to comply with the CPS.

**Private Competition** Actual and expected failures of commitment are costly. When entities do not fully believe that their partners will do their part in a cooperative scheme, they protect themselves by taking such steps as reducing or hedging their investments in the scheme, expending resources on protecting their investments or private information, or behaving strategically themselves. Commitment mechanisms are also costly. Reputation mechanisms incur the costs of collecting and disseminating information about behavior and the costs of punishment. Organizational mechanisms may distort incentives in ways that are undesirable as well as desirable.

Optimal commitment mechanisms equate the marginal cost of commitment with the marginal benefit achieved. These costs and benefits will vary depending on the design and simultaneous use of other commitment mechanisms. This is a feature that is exploited, for example, by the combined use of simple rules and reputation in the legal regimes developed by some trade associations. The optimal mix of mechanisms is the one that minimizes the net costs of commitment and the residual risks of default.

Determining the optimal design and combination of given mechanisms is a complicated economic problem that depends on many variables and can change rapidly. It is simply extraordinary to expect a bureaucratic institution such as the public legal system to achieve optimal legal design in these circumstances.

Achieving optimal complexity in legal rules requires an institutional means of determining when an increase in

non-human entities — corporations. Increased efficiency is, of course, also valuable in the legal relationships between citizens. The difference, however, is that when non-economic values such as justice and due process are at stake, the effort to increase efficiency has to take place within the context of the public regime for reasons of democratic legitimacy. One of the positive side effects of privatizing law in the corporate-commercial realm, however, might well be what we learn about how to deliver law in less expensive ways even while preserving access to publicly accountable legislative and judicial institutions.

**Competition From Public Regimes** One of the striking features of the history of private legal regimes is that they appear only to emerge where there is an absence of public law — as was the case in medieval Europe or in the rapidly developing world of cyberspace. There are a few reasons to think that a public regime, even as a default regime, may crowd out or otherwise pose an obstacle to the flourishing of private legal regimes.

Theoretically, the economies of scale, network externalities, and durability associated with a public legal regime all provide barriers to entry. Competing systems face a difficulty in getting off the ground and generating sufficient scale to challenge the durability and the vast store of prior experience captured in public law precedents. This does not mean, however, that the benefits of durability and the public regime's stock of precedent are not dissipated by the absence of competition over the substantive and procedural rules that are tied to precedent. As is the case with any insulated provider (whether insulated by economic advantages or legal fiat), the provider can exploit its monopoly power and grow lax in its responsiveness to change and potential innovation. For these reasons, public law may have to withdraw from the field or otherwise channel users into private regimes in order to spur the development of competition.

**The Role for Public Commercial Law** Privatizing commercial law does not mean that public commercial law disappears completely. Markets for private legal regimes require that the public regime “lend” its coercive power to the enforcement of private legal rules. They also require basic legal structure to create and maintain competition. This is a very familiar concept from the development of market economies: markets for goods and services do not emerge and function effectively in the absence of legal structure such as property and contract. They do not remain competitive without some intervention to control the exercise of monopoly power. Analogously, competitive markets for the private provision of legal structures cannot develop in the absence of even more basic legal structure.

The essential task for public law is to identify the points at which public legal structure is needed to facilitate the emergence and maintenance of efficient competition among private legal providers. Rules that optimally balance the interests of entities on both sides of a potential dispute may

require public rules to overcome the incentives for capture by certain players. The value of uniformity in law may, in some cases, outweigh all other concerns. In other cases there may be a role for public intervention to control the exercise of monopoly power when network externalities and economies of scale lead to excessive concentration in a market for private providers.

## CONCLUSION

THE HIGH COST OF COMMERCIAL LAW IS A STRUCTURAL problem. It has its roots in the monopoly exercised by the state over the administration of coercive dispute resolution. But whereas the state, for reasons of democratic legitimacy, must play the ultimate role in developing and administering law governing the lives and relationships of its citizens, private entities could play a much larger role in providing the legal regimes governing corporate-to-corporate commercial dealings.

By privatizing aspects of the corporate-commercial legal regime, we could gain the benefits of decentralized innovation and cost-reduction in the design of legal rules and, more generally, the design of commitment systems that incorporate legal rules in combination with reputational, technological, and organizational mechanisms. Privatization holds out the promise of reducing the cost and increasing the effectiveness of commercial law; it may also provide needed evidence of how we might reduce the cost of law in the public sphere. R

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