

## ***Privatizing Commercial Law: Lessons from the Middle and the Digital Ages***

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***Abstract:*** For the most part, the legal regime governing the emergence of the 21<sup>st</sup> C. commercial revolution is the product of the 19<sup>th</sup> C. Most importantly, our legal regime remains wedded to the role of public institutions, operating on bureaucratic rather than market principles, in developing the rules governing commercial relationships. While public law may be essential in the protection of the democratic values that shape the legal rights of individuals, the role of law in the commercial world is, or should be, principally about achieving efficient and productive commercial activity. In this paper I develop the rationale and principles for privatizing commercial law—meaning the private creation and enforcement of the substantive and procedural rules governing the commercial relations between economic entities—by exploring important examples of private legal regimes from the past and (futuristic) present. These examples are, principally, the merchant guilds and merchant courts of medieval Europe, the stock exchanges (particularly prior to SEC oversight), the private law developed by trade associations beginning in the late 19<sup>th</sup> century and, perhaps most intriguingly, the private regimes now emerging at an unprecedented pace on the Internet. Building on the analysis in a previous paper (*The Price of Law: How the Market for Lawyers Distorts the Justice System*), which documented the market failures traceable in large part to the monopoly provision of legal rules by the state as an insulated service provider, this paper examines how private legal regimes improve on public regimes in providing the legal structure necessary for efficient commercial relationships. The analysis sets out guidelines for exploring the central question of the appropriate role of the public regime in structuring private law-making institutions. Private regimes, it is argued, expose the process of law-making in commercial activity to competition and a far more efficient response to the complexities of modern commercial relationships and a rapidly changing environment. There is a need to examine the potential, therefore, to shift from what I term *transactional regulation*—public provision of the substantive rules of commercial relationships—to *organizational regulation*—public provision of the rules governing the private institutions that provide the substantive rules for commercial relationships. This shift and the guidelines drawn from both the middle and the digital ages are ones that take on immediate salience in light of the urgency of responding creatively to the revolution that is taking place in the commercial world and bringing commercial law into the 21<sup>st</sup> C.

# *Privatizing Commercial Law: Lessons from the Middle and the Digital Ages*

## **I. Introduction**

If you were a scientist from the 19<sup>th</sup> Century, transported (to your amazement) to the 21<sup>st</sup>, you would find yourself in a strange and confusing land. A global computer network, genetic manipulation, data carried on a beam of light, cloning, satellite communications and routine space travel.

If you were a lawyer from the 19<sup>th</sup> Century, however, you would feel pretty much at home: causes of action, motions, stare decisis, judges, juries and legal argument. Contract, property, tort. There would be a lot more law lying around and some fancy ways of finding it. But being a lawyer you would bring yourself up to speed on the details, adjust to the strategic demands of the situation and fit right in.

What if you were a business-person? (You would probably be a business-man.) Some things would look very strange indeed, like a lot of those technological changes. The scale, pace and complexity of production, accounting, distribution, regulation. E-commerce. It would all be, one might suspect, a little overwhelming. You would be selling goods and services you never dreamed of, in ways you never dreamed of.

But your confrere from the 1800s, your legal counsel, would at least be a familiar face, even if he is now a she, working in a law firm of 3,000 and communicating via email and fax. Your commercial relations would still be structured by contracts and subject to enforcement by litigation in state or federal courts, or by arbitration before a panel of industry experts. You would have property rights and trademarks, patents and

copyrights. You might be surprised at the fact that you could be sued in tort by consumers who bought your goods from a retailer, but you would not be surprised by the nature of how a tort claim could arise and be pursued. You would be aghast at the quantity of regulation your business was subject to, but you would understand by and large how laws and regulations were made, interpreted and applied. Dispute resolution—with your contracting partners, your competitors, your customers, your regulators—would look pretty much unchanged. The courts would look very unchanged. There would still be lawyers.

For those practicing law, the changes may loom much larger than the constants. The scale, the pace, the technology, the globalization of law: these are changes indeed. Against these changes, the fact that law is largely *unchanging* may be completely invisible: what law is today may seem to us as what law *is*. Period. That view of the world, however, is probably also the one that the 19<sup>th</sup> Century scientist held of Newtonian mechanics or the possibilities of human communication.

As lawyers, we need to shake ourselves awake to the possibility that commercial law might be capable of revolution as thoroughgoing as those that have occurred in the worlds of science and commerce itself. We need to ask, is the unchanging nature of dispute resolution in the commercial world a bulwark of stability in a world that refuses to stand still? Or is it a backwater, as yet untouched and unresponsive to the revolutions that have occurred beyond its shores?

There are good, structural, reasons to think it is the latter. Unlike science and commerce, law is a largely bureaucratic single-provider institution. The constituents of law—lawyers, judges, lawmakers—are members of a single profession with common

educational training and governance. They are trained to share a common approach to framing and resolving problems of ordering relationships and resolving conflicts. More importantly, the legal system holds a monopoly on coercive ordering and dispute resolution. As such it is an insulated service provider that changes in accordance with bureaucratic, not market, imperatives.<sup>1</sup>

Take as an example the process of civil discovery. The discovery regime is the product of rulemaking by a centralized body. In some dimensions, this is done through legislation and codification: by the legislature or by the courts in their rulemaking capacity. In others, it is done through common law processes, subject to ultimate appeal and reconciliation--that is, design--by the Supreme Court. Efforts to reform civil discovery to reduce the cost of civil litigation proceed via rulemaking and implementation in institutions—courts—ultimately coordinated by superior courts.

As documented by the RAND Institute's evaluation of one such large scale, and failed, effort—the Civil Justice Reform Act of 1990<sup>2</sup>-- efforts to reform civil discovery are subject to the usual bureaucratic obstacles: the reliance on centralized planning, political process and the inertia of a body that is not subject to external pressure. As RAND reports, the reforms designed by legislative committees have either no effect—largely because they cannot alter the guiding norms of judges and court personnel—or perverse effects—because increased judicial management increases the scope of contact and controversy between litigants and the courts and hence increases overall litigation costs.

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<sup>1</sup> I discuss these ideas fully in Gillian K. Hadfield (2000) "The Price of Law: How the market for lawyers distorts the justice system" 98 *Michigan Law Review* \*\*.

Compare this to what we are witnessing in the “reform” of telecommunications systems: DSL, ISDN, high-speed cable, internet-ready digital phones, satellite television, and so on. It is simply inconceivable that a centralized and insulated service provider could have developed—through research, logical analysis, committee deliberation and bureaucratic restructuring—this revolution. Whether we will be receiving information from the internet or directTV, over our cellular phones or in-car computers, via hand-held devices or infra-red units installed in the refrigerator door, is something that is emerging not from a top-down process of deliberation and reasoning, but from a bottom-up process of innovation, experimentation, and competition.<sup>3</sup> Without going so far as to say that whatever a market produces is good—and indeed what the market for lawyers in the context of the state’s monopoly on coercive dispute resolution produces is significantly bad<sup>4</sup>—it has to be clear that the process of centralized bureaucratic reform faces severe obstacles not faced by a decentralized market process. At a minimum, the decentralized process produces a much wider diversity of possibilities, and is able to display more creative leaps, than a bureaucratic process.

In this paper I discuss how and why we might open the regulation of commercial relationships up to 21<sup>st</sup> century innovations through privatization of the commercial legal regime. This is a project that requires attention to two key observations about the role of the state in a legal system. The first observation is that the state has a monopoly on the legitimate exercise of coercion; this is definitional of the state. The second observation is

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<sup>2</sup> See James S. Kakalik et al, *Just, Speedy, and Inexpensive? An Evaluation of Judicial Case Management under the Civil Justice Reform Act* (1996).

<sup>3</sup> Lest I be confused with an unabashed free-marketeer, I do not equate the outcome of “competition” with the theoretical outcome of “perfect competition”. Competition takes place in real markets and hence subject to real potential market imperfections and distortions.

that just because the state has a monopoly on coercion does not mean that the state must have a monopoly on rule-making and adjudication. The state does not have to provide the substance of law in order for relations, such as commercial relations, to be governed by the rule of law. Rules developed by purely private entities obtain the status of law when they are enforced by the state.

By making these two observations our starting point, we can ask the normative question, should we privatize some aspects of the commercial legal regime, and the positive question, if so, what might that look like? Put differently, what should and could be the role of law in supporting or structuring the emergence and growth of private bodies of law? Should we be exploring a shift from *transactional regulation*—that is publicly provided rules governing the substance of commercial relationships—to *organizational regulation*—that is, publicly provided rules governing the private institutions that in turn provide the rules governing the substance of commercial relationships? These are the questions I explore in this paper.

## **II. The Commercial Legal Regime: Myths and Reality**

It is conventional to think of the commercial legal regime as already characterized by “private law”. Contracts are the infrastructure of commercial relations and the instrument by which commercial parties create a private ordering for themselves. The content of contractual obligations is determined and chosen by the parties themselves. Even the means of enforcement of those contractual obligations can be chosen and delegated to private entities that compete for business in the market for arbitrators. According to some observers, for good or ill, commercial arbitration is already

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<sup>4</sup> See Hadfield (2000)

privatizing law.<sup>5</sup> There are, however, two myths obscuring the extent to which commercial law is, in fact, privatized under current regimes.

### **A. *The myth of private ordering***<sup>6</sup>

Contracts establish obligations and rights for parties that would not exist at law but for the contract. In that sense, contracts do give rise to a “private law” of sorts. But the contours of private orderings remain fully private only to the extent that they remain uncontested, and therefore merely latent from a legal point of view. Once contested, the public law of contract doctrine determines those contours. The obligations are those that contract law selects subject to canons of interpretation, the parol evidence rule, and the public understanding of contractual “intent”. Whether they are operative or not is judged according to doctrines of mistake, fraud, duress, unconscionability and public policy. Whether they have been performed is evaluated against doctrines of substantial performance, material breach, frustration and impossibility. How they will be remedied is determined by legal principles of expectation, reliance, restitution and doctrines limiting liquidated damages or specific performance.

Sometimes the specific legal obligations created by a contract will, to be sure, be in large measure designed unilaterally by a private institution. In consumer transactions, for example, the terms are often set by a seller’s “contract of adhesion” bundled on a take-it-or-leave-it basis with the goods or services being sold. In employment relationships, internal grievance procedures and policies will often be crafted and

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<sup>5</sup> Stephen J. Ware “Default Rules from Mandatory Rules: Privatizing Law through Arbitration” 83 *Minn. L. Rev.* 703 (1999). See also Edward Brunet “Replacing Folklore Arbitration with A Contract Model of Arbitration” 74 *Tulane L.Rev.* 39 (1999).

implemented on a unilateral basis by the employer. In both these settings, as a practical matter, the relationship is largely governed by private rules. Nonetheless, at the point at which these rules are invoked, the public law governing the contested terms emerges as the source-in-fact of their legal authority and dimension. “Adhesive” contract terms are applicable only to the extent contract doctrine makes them stick. Employers’ internal grievance procedures govern only to the extent an employee is without external legal recourse. Although private institutions do play a significant role in the substantive content of the legal rules in these settings, they do so only within the substantive bounds and under the substantive oversight of the public law.

### ***B. The myth of private arbitration***

“Private” arbitration is a creature of contract and so is as much a matter of “public” law as any contract. Indeed, it is more so. A contract term providing for arbitration is subject to interpretation and enforcement according not only to the body of contract doctrine, but also to the law embodied in the Constitution and statutes such as the Federal Arbitration Act<sup>7</sup> (“FAA”). In mapping the contours of arbitrability, the law of arbitration travels the hills and ravines of the constitution and complex principles of federalism.<sup>8</sup> Can a contract term providing that “all disputes” shall be arbitrated extend to mandate arbitration of statutory claims arising under the antitrust law?<sup>9</sup> Civil rights

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<sup>6</sup> See also Margaret Jane Radin and R. Polk Wagner “The Myth of Private Ordering: Rediscovering Legal Realism in Cyberspace” 73 Chicago-Kent Law Review 1295 (1998).

<sup>7</sup> 9 U.S.C. s.1 et. seq.

<sup>8</sup> See e.g. *Volt Information Sciences v. Board of Trustees of Leland Stanford Junior University* 489 U.S. 468 (1989).

<sup>9</sup> Yes, according to *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth Inc.* 473 U.S. 614 (1985), because “by agreeing to arbitrate a statutory claim, a party does not forego the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum.” *Id.* At 628.

law?<sup>10</sup> Disability law?<sup>11</sup> Can a state legislature prohibit the arbitration of claims under its own statutes?<sup>12</sup> Questions such as these make “private arbitration” very public indeed.

The most public part of “private arbitration”, however, is found in the substance of the law it applies. With rare exception, the law in private arbitration is the same law that would be applied if the parties litigated their case in a state or federal court. It may be applied with a “fudge factor” for compromise or equitable considerations.<sup>13</sup> It may be applied in a loose manner with no recourse for appeal.<sup>14</sup> But the doctrines and principles organizing the arguments in the case, and against which the performance of the arbitrator can be judged, are those of the public law. Some arbitrators go to great lengths to emphasize this.<sup>15</sup> Others advertise a more rough and ready form of justice, dispensed according to equitable principles rather than legal rules.<sup>16</sup> But even in the latter case, although the fit may be loose, the framework is still the relevant public law.

Indeed, a mere contract clause—or statutory provision—to arbitrate a dispute cannot purport to do anything except provide an alternative forum, but not substantive law, for dispute resolution. The public law of arbitration in the U.S., specifically the

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<sup>10</sup> Compare *Seus v. John Nuveen*, 146 F.3d 175 (3d Cir. 1998) (arbitrable) with *Duffield v. Robinson Stephens & Co.* 144 F.3d 1182 (9<sup>th</sup> Cir. 1998) (in-arbitrable).

<sup>11</sup> Yes, according to *Gilmer v. Interstate/Johnson Lane Corp.* 500 U.S. 20 (1991).

<sup>12</sup> No. See eg. *Perry v. Thomas*, 482 US 483 (1987) (California cannot exclude arbitration of claims under California Labor Code). This point is discussed more fully in Stephen Ware “Basic Principles of Arbitration Law: Successful Challenges to Arbitration Agreements” Practising Law Institute PLI Order No. B0-00C2 February, 1999 Arbitration of Consumer Financial Services Disputes.

<sup>13</sup> See Ware, *supra* n. \* text at footnote 78.

<sup>14</sup> Of course, as a practical matter, this is true of many cases in the public courts as well. What goes on in family law courts, for example, bears little relation to the law of the land because the threat of appeal is virtually non-existent given the extraordinary expense relative to the resources of the vast majority of family law litigants.

<sup>15</sup> This is true of the National Arbitration Forum, for example. See their website at [www.arb-forum.com](http://www.arb-forum.com) and the observations in Brunet, *supra*.

<sup>16</sup>The American Arbitration Association, for example, generally opposes the “judicialization” of arbitration, although its own procedures borrow substantially from judicial procedure. See the discussion in Brunet at \*\*.

legitimacy of arbitration and the arbitrability of statutory claims--rests on precisely that limitation of private arbitration.<sup>17</sup>

In international commerce, where arbitration is commonplace, parties can slip free of the bounds of particular bodies of public law by designating which country's law will govern their contract. Doing so may give the parties greater freedom, depending on the substantive law of arbitrability in the country they choose, to design their own legal regime through arbitration. Unless there is a country whose laws do not ultimately shape the substance of the contract between the parties, however—and in the international arena these laws will include those established by international treaties and conventions as well as domestic laws specifically governing the terms of transnational contracts—even in this arena it remains the case that the framework is public law. Only in those cases where a non-governmental organization has established a substitute *legal system* can it be said that there is truly “private” arbitration.

What we need to explore in assessing the desirability and the potential for privatizing commercial law is the private development and application of substantive rules governing commercial relationships and disputes. This is what I mean when I refer to a private legal regime: substantive *and* procedural rules developed and applied by a private entity, although subject to enforcement (but not review or other oversight) by the public authority.

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<sup>17</sup> Shearson/American Exp. Inc. v. McMahon, 482 US 220, 232 (1987) (“streamlined procedures of arbitration do not entail any consequential restriction on substantive rights.” “Although judicial scrutiny of arbitration awards necessarily is limited, such review is sufficient to ensure that arbitrator’s comply with the requirements of the statute.” )

### **III. Private legal regimes past, present and future**

According to the above definition of “private” our current commercial law regime is by and large a public regime. But this is not to say that there are not and never have been examples of private legal regimes. From the middle ages to the infant Digital Age, private legal regimes have emerged from time to time and place to place, usually to fill niche left open by the public regime. By examining these exceptions in more detail, we can identify the lessons they hold for the project of privatizing commercial law more widely.

#### ***A. Merchant Guilds and the Law Merchant***

One of the reasons our legal system has remained stuck in the 19<sup>th</sup> C is, paradoxically, that our historical perspective on the law is too modern. Our commercial legal structure seems “necessary” because we do not remember that it was not always as it is now.

At the turn of the last millenium, in medieval Europe, the nation state had yet to emerge as the monopolist of legitimate force. Coercion was not systematically organized through legal structures beyond those within localized communities. In the commercial world at this time—a time characterized by the expansion of long-distance trade and resulting economic growth—legal relations beyond the domain of a local ruler essentially did not exist. Long-distance traders venturing beyond the protection of a local ruler had little recourse to an organized legal system.

Long-distance commercial relations in this period, however, faced the same fundamental obstacles that modern commercial relations do, namely the problems of commitment over time and space. As Avner Greif has documented with exceptional

care<sup>18</sup>, merchants who wished to sell their goods in foreign lands faced the problem of getting their goods over those long distances and collecting their revenues in return. Merchants could travel themselves and engage in spot market transactions with buyers<sup>19</sup>, but this was costly. The expansion of long-distance trade that characterizes this period rested on the development of agency relationships: agents carried the merchant's goods and sold them at the fairs and markets in foreign locales on behalf of the merchant. To develop these relationships, however, merchants had to solve fundamental commitment problems.

First, the merchant had to rely on the commitment of the agent to deliver the goods to the foreign location and return the revenues. What was to stop the agent from making off with the goods and keeping whatever revenues he could make by selling them? Not a legal system. The merchant could potentially obtain assistance in the foreign land in retrieving the goods or the revenues from the foreign ruler. But what was to stop the foreign ruler himself from confiscating the goods? Not law. Nor was there law to enforce the lending arrangements that merchants entered into or to protect the buyer of a merchant's goods from being cheated in quality or weight or quantity.

To some extent, commitment was provided by the interest of any one of these economic actors in maintaining his reputation and hence his ability to continue trading

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<sup>18</sup> See Greif, Avner "Reputation and Coalitions in Medieval Trade: Evidence on the Maghribi Traders" *Journal of Economic History*, Vol. 49, No. 4. (Dec., 1989), pp. 857-882; "Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition" *The American Economic Review*, Vol. 83, No. 3. (Jun., 1993), pp. 525-548; "On the Political Foundations of the Late Medieval Commercial Revolution: Genoa During the Twelfth and Thirteenth Centuries" *Journal of Economic History*, Vol. 54, No. 2, Papers Presented at the Fifty-Third Annual Meeting of the Economic History Association. (Jun., 1994), pp. 271-287.

<sup>19</sup> A spot market transaction is one in which both sides of the exchange occur simultaneously so as to minimize, indeed eliminate, the problem of commitment that arises when one sides performs before the other.

relations in the future. This one-on-one reputation mechanism, however, was only powerful to the extent a given merchant had the capacity to extract (and share via taxes collected by the ruler) pure rents from trade (the margin of revenues over costs and a return to capital and risk). This required that the volume of trade remain below an efficient level, that is, the level at which the rents from trade are dissipated by entry into the market and competition.

The commercial revolution and economic expansion of this period was enabled by the development of private organizations of merchants (such as merchant guilds) and merchant courts (“the law merchant”) enforced by coalitions of merchants. These organizations relied on a reputation mechanism—retaliating for a breach of a commitment through the withdrawal of valuable future trade with the offender—by coordinating the responses of a group, rather than an isolated, merchant. As documented by Greif<sup>20</sup> and analyzed in game theoretic terms by Greif, Milgrom and Weingast<sup>21</sup>, the merchant guilds secured the backing of foreign rulers by organizing guild-wide embargoes in the event that a ruler condoned or committed violations of the property or contract “rights” of one of its members. Accomplishing the embargo itself required a second-level of discipline, namely the punishing of a merchant who traded around the embargo. For this purpose, the guild had to secure from the local ruler the right in its own locality to control access to trading fairs and markets, in order to “freeze out” an errant member of the guild.

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<sup>20</sup> See *supra* n. 18.

<sup>21</sup> Avner Greif, Paul Milgrom and Barry Weingast “Coordination, Commitment and Enforcement: The Case of the Merchant Guild” 102 *Journal of Political Economy* 745 (1994).

The emergence of commercial “law” in this period was thus largely a *private* phenomenon, in the sense that the power coordinated by the merchant organizations was administered according to substantive and procedural rules created (not necessarily codified) by the merchants themselves. To the extent that there was a concentration of coercive force exercised by a local or regional ruler, that “public” power was limited to the enforcement of the granting of exclusive control over trade to a merchant guild or merchant court<sup>22</sup>: the public entity enforced the authority of the private merchant organization to establish the rules and rights of trade.

The story of the merchant guilds and the merchant courts is not however merely, or even perhaps importantly, a story about the exercise of organized coercive power. It is a story about information. Collecting, assessing and transmitting information is at the heart of a reputation mechanism. The effective extent of the mechanism is therefore a function of the cost of collecting, assessing and transmitting information. Retaliations for violations of a commitment can only be coordinated among the members of an organization if the members of the organization learn of the violation in a manner that permits a coordinated response and at a reasonable cost. As emphasized by Milgrom, North and Weingast<sup>23</sup> merchant courts played a vital function in the collection, preservation and dissemination of information among the participants in a merchant

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<sup>22</sup> For example, the local lord who established a trading fair would grant the right to operate a court to the fair’s organizers. These courts were paid by the case and gave rise to a profitable business, emphasizing the private nature of this commercial regime. See Greif “On Institutions that Facilitate Impersonal Exchange: From the Community Responsibility System to Individual Legal Responsibility in Pre-Modern Europe.” (January 1999)

<sup>23</sup> Paul Milgrom, Douglass North and Barry Weingast “The Role of Institutions in the Revival of Trade: The Medieval Law Merchant, Private Judges and the Champagne Fairs” 2 *Economics and Politics* 1 (1990).

community, reducing the cost of information and facilitating the development of trading institutions.

Seen in this historical perspective, commercial law emerged as a private institution and predated the widespread emergence of the public law structure of contract and property we have now. The private regimes of medieval Europe still rested on a “public” exercise of coercive power, albeit a less organized and more fragmented one than we would recognize today. The private organizations that organized trade were themselves supported and/or constituted in that role by the public authority. Nonetheless, what this history allows us to do is to imagine, at least, a commercial law that is neither developed nor delivered through public institutions. The economics of the private commercial legal regime of the medieval period provide us with some guidance as to what functions private systems, at a minimum, have to fulfill in order to structure efficient relationships.

It would be a mistake, of course, to interpret this as a call for a return to the merchant guilds of yore. It is a call to remember that what is necessary to support commercial relationships is not “commercial law” as we now understand that term, but rather a set of institutions that perform the function of securing the coordination and commitment needed for economic activity.<sup>24</sup> Just as the medieval merchants’ monopolies were replaced by public legal regimes of contract and property law, so too may the state’s monopoly over commercial law yield to an increased role for private organizations.

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<sup>24</sup> Greif (1997) makes this point, but with a less nuanced concept of a “legal system”. For an overview of the role of institutions, particularly commitment enforcement mechanisms, in economic development see Douglass North “Institutions” 5 *Journal of Economic Perspectives* 97 (1991).

## **B. Trade Associations**

Modern economies also have pockets in which private organizations provide most of the commercial “law” governing a set of relationships. Lisa Bernstein has documented these examples extensively.<sup>25</sup> Diamond traders agree to be governed by the legal regime generated and delivered by their association.<sup>26</sup> So too do members of a variety of trade associations.<sup>27</sup> These associations create the substantive rules governing exchange relationships among the members of the organization, establish the procedure by which complaints about departure from the rules will be adjudicated and remedied, and write the “constitutional” provisions governing the process by which rules will be reviewed and potentially changed. The associations also make use of their ability to collect and convey information outside of an adjudication setting—the reputation mechanism we can recognize from the medieval guilds—by publicizing defaults under the rules, whether or not the defaults have resulted in an unfavorable adjudication for the defaulter.

Unlike the medieval merchant guilds, however, these private legal entities are structured under an extensive system of public law, particularly the law of contract and arbitration. The source of the organization’s “power” to coerce participation in its legal regime stems, in a legal sense, from contract law created and administered by the state. The power to enforce remedial orders arising from the private legal regime rests on public law with respect to arbitration agreements in particular. In a practical sense, an organization may have market power to accomplish these coercive acts—refusing to deal

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<sup>25</sup> For an overview see Bernstein, Lisa entry *The New Palgrave Dictionary of Economics and Law* (1998).

<sup>26</sup> Bernstein, Lisa “Opting out of the Legal System: Extralegal Contractual Relations in the Diamond Industry” 21 *J. Legal Stud.* 115 (1992).

<sup>27</sup> Bernstein, Lisa “Merchant Law in a Merchant Court: Rethinking the Code’s Search for Immanent Business Norms” 144 *U. Pa. L. Rev.* 1765 (1996)

with those who refuse to enter into contracts transferring legal authority to the organization—but, unlike the medieval guilds, the power is not created by public authority. Indeed, public authority acts as a constraint on the power of the organization to require participation, through antitrust law, libel law, and so on.

One of the most important observations to make about these private legal regimes—other than their relative rarity<sup>28</sup>—is how *different* they look from the public legal regimes they displace. Although there are individual differences, on the whole these regimes are made up of simple rules subject to literal interpretation and application. This is something to which public legal regimes sometimes aspire<sup>29</sup> but rarely achieve. In these public regimes, based on common law principles of reasoning,<sup>30</sup> a natural entropy in legal reasoning introduces complexity fairly rapidly into even the initially simplest laws. For when the case arises in which the literal application of a simple rule departs from a fundamental sense of the “right outcome” in a given situation, legal reasoning begins to interpret and extend and exceptionalize.<sup>31</sup> In these private regimes, however, there are “constitutional” provisions—rules about how rules are made—that ensure the stability of simple rules literally applied. They do so by disconnecting adjudication from law-making by overtly intercepting common law-type reasoning. In these regimes, when the literal application of a rule departs from the underlying merits of the case, the rule is applied literally nonetheless and the gap is dealt with in potentially

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<sup>28</sup> Although we do not have a measure of the fraction of commercial disputes that are channeled through these private trade association regimes, Bernstein’s work suggests that they are restricted to sales contracts in commodities with a homogeneous and organized trading association.

<sup>29</sup> See Epstein, Richard *Simple Rules for a Complex World* (1995).

<sup>30</sup> This is not only true in those areas in which law is explicitly “common law.” As Calabresi has emphasized, even statutory law develops in a common law fashion. Calabresi, Guido *A Common Law for the Age of Statutes* (1982).

<sup>31</sup> I discuss this “entropy” in *The Price of Law*.

two different ways: the participant who has benefited from a “loophole” or the gap between the literal rule and the underlying sense of what is right or just may have its advantage-taking publicized and may suffer trading consequences through the reputation mechanism. More formally, the rule may be referred to the rule-making aspects of the legal regime for consideration of the question, separate from the adjudication, as to whether there is a need to change the rule to eliminate a gap between the simple rule and the complex underlying goals and principles.

### ***C. Stock Exchanges***

Modern stock exchanges also operate within a quasi-private legal regime. Companies listing their stock with an exchange agree to abide by rules, about the types of stock they can issue or the voting rights of shareholders for example, established by the exchange. Members of the exchange agree, as a condition of access to the exchange, to comply with its rules, including certification, disciplinary and dispute resolution procedures. Exchanges, most notably the New York Stock Exchange and the National Association of Securities Dealers, act as complete regulatory agencies in the sense of performing monitoring, investigation, hearing and enforcement functions.

Public contract and arbitration law is, again, in the background of these legal regimes. More substantially, since the 1930s, these regimes have operated under close supervision by public securities law and the public regulatory body, the Securities and Exchange Commission. Rules promulgated by an exchange must be approved by the SEC; adjudications of rule violations by members are reviewable by the SEC and appealable in the public courts.

Among the enforcement tools used by the exchanges, including fines and suspensions, expulsion in particular harkens back to the medieval guilds. In the case of the securities market, however, the power of expulsion derives not from a grant of monopoly by the public authority but from the network economies accruing to the exchange and, in some cases, restricted access to the exchange. The New York Stock Exchange, for example, has limited the number of “seats” (members) (currently 1,366) since 1868<sup>32</sup>. The value of a seat--representing (a portion of) the return to acting as a broker for trades in listed securities above and beyond that available by trading in unlisted securities or in other markets--is currently around \$2 million.<sup>33</sup>

Exchanges compete with each other and with other markets, such as the NASDAQ and now electronic direct trading systems such as eTrade, in the provision of services to investors and publicly traded companies. One of the important dimensions on which they compete is the *legal regime* or governance structure they offer.<sup>34</sup> In theory, at least, all of the relevant participants—publicly traded companies, investors, brokers and traders—can move their business elsewhere if the rules established by a particular trading institution are too costly or too cumbersome or insufficiently protective. In theory, at least, there is an incentive in the institutions to devote resources to innovation and efficiency in the design of the rules governing trade and to respond in an efficient way to change.

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<sup>32</sup> See [www.nyse.com](http://www.nyse.com) “Seat Prices”.

<sup>33</sup> The highest price ever paid for a seat was \$2.65 million in August, 1999.

<sup>34</sup> For a discussion, see Macey, Jonathan “The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges” 75 *Cornell Law Review* 1007 (1990); Macey, Jonathan and O’Hara, Maureen “Regulating Exchanges and Alternative Trading Systems: A Law and Economics Perspective” 18 *Journal of Legal Studies* 17 (1999).

I have applied the caveat “in theory” because there are two sources of constraint on the competition between exchanges and other trading systems and hence the development of truly private law in this setting. First, the rules established by a given institution must be approved by the public regulatory agency, the SEC. They must be consistent with the substantive public law, specifically the Securities and Exchanges Acts and the regulations promulgated thereunder.

Furthermore, the application and enforcement of the private rules applied by the trading institution are subject to review by the SEC and ultimately the courts. One consequence of this is that the procedures and approach to reasoning and rule development in these settings maps that of the courts. Unlike the private regimes established by trade associations, rule adjudication and rule development are fused in the “private” securities’ regimes as they are in the public regime. This leaves open the question of whether the reliance on common law reasoning and public law procedures is a competitive response to market needs or a constraint on competitive legal development imposed (perhaps legitimately) by the public structuring of this “private” regime.

A second constraint on the competition between alternative trading institutions is a form of market failure.<sup>35</sup> Trading institutions are subject to network externalities: for a number of reasons, the more participants in the institution, the greater the value of participation. Market participants understand this well in terms of liquidity, namely the availability of potential trading partners at a given price. The more participants in the market (whether directly or indirectly via market makers who stand ready to buy or sell at posted prices), the more responsive the market to information and the less susceptible to

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<sup>35</sup> For an extensive discussion of market failure at the exchange level see Macey and O’Hara, *supra*.

volatility as a result of trades at disequilibrium prices that have yet to efficiently process information. The more efficiently information is processed and reflected in stock prices, the better are prices as an indicator of the financial status of a publicly traded company.

Another reason that trading institutions are subject to network externalities comes back to the private legal regimes established by those institutions. Securities traded under a common set of rules can be compared at lower cost than those traded under different sets of rules. Learning the rules of a system is a costly process in the same way (although not to the same extent) that learning an operating system on a computer is a costly process. For a company choosing where to list its stock, this can be a factor: listing with a less well-known, less extensively used, institution will create a cost for some potential investors that alternative investments do not.

As a result of network externalities and the increasing returns to the scale of a trading institution, competition among trading institutions will be distorted. Because the legal regimes offered by these institutions come bundled with access to the institution, some innovations and efficiency-promoting developments in private legal regimes may be impeded by the barrier to entry that scale imposes. How serious a barrier this may be is a subject for further study; the emergence of direct internet trading and the proliferation of trading institutions that is resulting may be sufficient evidence that the barrier is not a significant one.<sup>36</sup>

The lesson for our purposes here is to identify this potential obstacle to the development of efficient private regimes and to recognize that the role of public law may be that of ensuring the competitiveness of private legal regimes and not traditional

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<sup>36</sup> See *id.*

oversight in the sense of regulating the content of these legal regimes. I call the latter *transactional regulation* and the former *organizational regulation*. As an example, it may be that the true competition over legal regimes requires, as a matter of organizational regulation, that the law-providing function be unbundled from access to the exchange by, for example, requiring exchanges to select a legal regime offered by independent market providers specializing in, and competing over, this function, rather than tying access to their exchange to acceptance of their rules.

#### ***D. Private legal regimes on the Internet***

Just as the Commercial Revolution gave rise to private merchant codes to provide the legal structure necessary for long-distance trade in the absence of a public legal regime, so too is the Digital Revolution generating private legal regimes. To be sure, the developments here are so embryonic, the pace of change so rapid, and the potential for public regimes to displace private regimes so real, that it is an ephemeral project indeed to document the nature of these regimes. But it is on the Internet that we find legal regimes evolving in a decentralized way in tandem with the rapid technological developments of e-commerce. It is also on the Internet that we find clues as to what law might need to look like in order to keep up with the emergence of the new ‘digital’ economy.

Like the medieval world prior to the establishment of nation states, the world of cyberspace is largely a legal vacuum. The need for a legal structure to support the relationships in cyberspace, however, is as fundamental as it was in medieval times. To some extent, familiar contract law is stepping up to the plate: providers on the internet attach terms (including choice of law and dispute resolution provisions) to their goods

and services via the cyberspace version of the standard form contract: “click-wrap”. The legal regimes emerging in cyberspace suggest, however, far more revolutionary changes are at hand than mere adaptations of existing legal structures.

The legal regime of the internet infrastructure itself is a remarkable example of both the possibility of privatization and the potential for the state to recognize the role for competition and the private provision of law. The functioning of the internet depends, at least currently, on the use of a common identification and communication system (“protocol”) and central or “root” servers to route messages to the appropriate computers. Computers that operate as servers are identified with a unique set of numbers known as the Internet Protocol (IP) address. Blocks of these numbers are associated with domain names, beginning with top level domains such as .com, .net and .org. Second level domain names—web addresses such as www.cars.com—are then associated with unique IP values in these blocks.

Originally, when the Internet was a system developed and operated by the U.S. Government (specifically the Department of Defense and the National Science Foundation) IP numbers and associated names were assigned and a list maintained by an individual<sup>37</sup>, and later an informal organization known as the Internet Assigned Numbers Authority, working on the project under contract with NSF. With the move to commercial uses for the internet<sup>38</sup>, in 1991-92 NSF solicited competitive bids from private companies to take over the function of domain name registration and the assignment of IP values. This bid was won by Network Solutions Inc., a for-profit firm, which became responsible for the allocation of the blocks of IP values associated with the

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<sup>37</sup> This person was the late Dr. Jon Postel of the University of Southern California.

.com, .net, .org, .edu and .gov top level domains. The top level domains are maintained on what is known as the “root server system”, a set of (in 1998, 13) file servers containing the authoritative database of the unique numbers and associated names identifying individual computers (network servers) on the Internet.

With the rapid growth and global expansion of commercial activity on the internet, pressure to introduce competition and privatization into the management of the internet infrastructure led in 1998 to the U.S. government’s transferring of responsibility over the gatekeeping function to a private non-profit corporation established for that purpose: the Internet Corporation for Assigned Names and Numbers. ICANN is constituted with a Board of Directors with global representation and funded via domain name registration fees. ICANN is responsible for directing the allocation of IP number blocks to regional Internet number registries<sup>39</sup>, overseeing the operation of the authoritative Internet root server system—including developing policy for the possible introduction of new top level domain names to the root system (such .firm, .store)—and coordinating the assignment of new technical parameters as needed to maintain universal connectivity.

ICANN, which began operations in September 1998, took over responsibility for accrediting entities (including private corporations) to act as domain name registrars. Currently there are approximately 100 corporations accredited to register secondary domain names in the .com, .org and .net top level domains, thus introducing competition into the field originally occupied by NSI on a monopoly basis. NSI, under a modified

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<sup>38</sup> Congress gave statutory authority to NSF’s network to allow commercial activity in 1992.

<sup>39</sup> For example, ARIN is the regional registry for North America, RIPE the registry for Europe.

contract with the US government<sup>40</sup>, undertook to act as the registry administrator under the Shared Registration System established in the spring of 1999: coordinating the registration activity of the individual registries (of which it remains one). Thus, when an individual attempts to register a domain name such as [www.supershop.com](http://www.supershop.com)<sup>41</sup> with one of the many competitive registries in the market (such as Signature Domains Inc.), the registry checks with the SRS on NSI's system to see if the name is available. If it is, Signature Domains Inc. can register that name on behalf of its customer and collect its fee. In practice, registration is, through market demand, bundled in various ways with other services such as assistance in establishing a web site or e-business, domain name "parking", "under construction" web pages, email services and web-hosting services to link existing web sites to the new domain name.

The legal dimensions of this privatized regime arise from the nature of the "property" right in a domain name. Physically, because the (non-military) internet is a system of root servers—access to which is now ultimately controlled by ICANN subject to ICANN's operating agreement with the US government—a user gains exclusive rights to a domain name because ICANN oversees a system that will assign only one IP number (or block of numbers) to a given name. ICANN has the power to exclude a domain name simply by not associating the domain name with an IP number in the protocol that allows computers "on" the internet to communicate.

The more specifically "legal" aspect of the regime arises when there are disputes about the rights to a given domain name. ICANN has established a domain name dispute

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<sup>40</sup> Agency responsibility in the US government has now shifted to the Department of Commerce and specifically the National Telecommunications and Information Administration.

policy and system for these purposes: the Uniform Dispute Resolution Policy. This consists of rules to resolve conflicts, a process by which conflicts will be resolved and a remedy. Essentially the rule is that names are assigned on a first-come-first-served basis. Hence whoever was forward-looking enough to realize that someone would want the domain name [www.cars.com](http://www.cars.com) and registered it first, they would have the right to use that name exclusively or to sell it to the highest bidder. The exception to this rule is when the first registrant has registered in bad faith a name that is the same as or confusingly similar to another entity's trademark.

The process by which conflicts are resolved under the UDRP is another example of privatization in this legal regime. ICANN accredits domain name dispute resolution providers, beginning with National Arbitration Forum and the World Intellectual Property Organization in December 1999 and the dispute.org/eResolution Inc. consortium as of January 2000. These private providers, for a fee established in the marketplace, accept complaints and determine the rights to a contested domain name according to ICANN policy and procedures. The provider then instructs ICANN whether or not to cancel or transfer a domain name and publish their decisions on their website. This process operates separately from legal processes under the public law of intellectual property.

This system is remarkable as an example of a private legal regime. Even though the rights being allocated and adjudicated pertain to access to what is ultimately a public resource, the substantive and procedural law governing these rights are developed and implemented by fully private organizations. The state plays only the role of establishing

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<sup>41</sup> Although I just “made up” an arbitrary name for purposes of this example, this name has in fact been

the “constitutional law” of a primary private entity: the relationship between the private entity and the public resource, in this case the organizational conditions that must be met for ICANN to obtain the authority to control the root server system.

Compare this with traditional approaches to “single-provider” infrastructure, such as conventional public utilities. In these traditional approaches, public agencies have assumed responsibility for the oversight and direct regulation of the conduct of any private parties involved in the provision of the goods or services of these utilities: determining the conditions under which consumers must have access (“common carrier” provisions for example) and regulating rates and products. Public law has acted *directly* at the level of the substance of the market relationship between the ultimate consumer and the private service provider. This is *transactional regulation*.

By way of contrast, in the case of Internet infrastructure access and pricing, the US government (laudably) has focused the role for public law on the minimal structure necessary to create private institutions that will then operate under market incentives to determine the substance of the relationship between ultimate consumers and private providers. This is *organizational regulation*.

This is a fundamental shift in the understanding of regulation and public law. Instead of asking, what should access and price be in this market, and then inscribing that into public law, the Internet model asks, what public law will facilitate the emergence of private entities to determine competitive access and price through the market. These are *very* different questions. Transactional regulation looks at only at public law’s role in

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registered and is operating as a virtual shopping mall.

correcting market failures. Organizational regulation looks first and foremost at public law's role in structuring markets with minimal market failures.

Private legal institutions are emerging in spontaneous ways on the Internet as well, albeit under the shadow of potential public law intervention. The solutions may be 21<sup>st</sup> century but the problems are medieval: how can individuals and entities doing business trust that their trading partners will do as they say? In the Internet setting, this means, how can consumers and businesses be sure that the information they transmit online will remain confidential and used only for the purposes to which they have consented? How can they ensure that charges will be made against a credit card only as authorized, goods and services delivered as ordered? How can they ensure that the entity they are dealing with is in fact the one they think it is?

Solutions to these challenges are rapidly emerging on the Internet and are an example of the fluid relationship between reputational, organizational, technological and legal means of overcoming commitment and trust problems in commerce. Consider the problem of security on the internet. Technology, in the form of encryption, ensures that information sent over the internet cannot be "seen" by anyone who does not have access to the "key" to the encryption. Current encryption is evolving as a "public key infrastructure" which allows information to be not only encoded but also for its source to be verified.

This infrastructure rests on a pair of "keys" (mathematical algorithms), which are the inverse of each other. One is distributed as the public key; the other is retained as the private key. A sender encrypts a message with the private key. A recipient who has the public key (which can also be sent along with the message to an intended recipient) then

decodes the message. This process accomplishes two things. Only those who have been given the public key can decode the message (secured transmission). And only those who have the private key can send messages that are capable of being decoded with a given public key (identity verification of the sender).

Encryption technology alone, however, will not overcome the trust problem completely. If I receive a message to which is attached the public key allowing me to read the message, how do I know that it was sent by the entity that purports to own this public key? The solution emerging on the internet is the provision of identification/certification services by private firms. An online entity that wishes to be capable of positive identification applies for a digital certificate from a certifying authority. A recipient who wishes to confirm the identity of a sender who has obtained a certificate contacts the certifying authority.

The revolution of the internet is that these steps, which sound cumbersome and infeasible in real space, are instantaneous and virtually costless in cyberspace and can be provided by market entities. VeriSign Inc., for example, is currently a leading provider of encryption technology and public key infrastructure. An online entity can purchase from VeriSign a package that includes the public key infrastructure technology, a digital certificate (maintained by VeriSign on its secure server) verifying that messages sent with a public key are sent by the entity to whom VeriSign distributed that key, an audit service that monitors the entity's use of and continued security of their public key infrastructure (guaranteeing that this entity is the only one with access to the private key for example) and a "legal" authority to revoke or suspend a certificate in the event that an entity does not pass an audit. The authority of VeriSign to manage the use of the seal is governed by

its Certification Practices Statement, which sets out the requirements and procedures for certification, ongoing auditing, certificate revocation and dispute resolution.<sup>42</sup>

This is all made feasible by VeriSign's seal: a "trustmark" which the purchaser of this package posts on its website. Clicking on the seal takes the user to VeriSign's repository on their secure server, displaying the current information and status of the digital id for that website. The seal signifies that the website uses VeriSign encryption technology and allows both the identity of the website and the validity of the seal to be verified at the click.

This again does not eliminate the problem of trust, because there is still the question of how the user knows that it has contacted VeriSign when it clicks on the seal and that VeriSign can be relied on as a source of information about the encryption technology of the website displaying the seal. But what this structure does do is take a commitment problem which arises at thousands or even millions of websites and folds them back to a commitment problem for a single entity: VeriSign Inc. VeriSign Inc.'s commitment problem is then addressed both by their submission to audit themselves by entities such as KPMG, and, more importantly, by the market.

Fundamentally, this structure moves the commitment problem from an entity (the individual e-commerce website) that faces incentives for security breaches (because it is costly to maintain security or because there are gains to be had from distributing information that is supposed to be kept secure) to an entity that faces incentives for security maintenance. VeriSign Inc.'s value as a company rests on its ability to deliver secure systems and its reputation for following through with audits and justified

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<sup>42</sup> VeriSign's CPS can be seen at [www.verisign.com](http://www.verisign.com).

revocations. VeriSign's seal gains value only to the extent that VeriSign Inc. is able to satisfy consumers that it means something. In this sense, VeriSign supplies to the seller but responds to the buyer in the final market.<sup>43</sup>

Seal programs are also being developed by private entities to deal with privacy concerns and even ordinary consumer protection concerns in e-commerce. TRUSTe, for example, is a non-profit corporation founded by the Online Privacy Alliance (a group of leading internet firms such as Microsoft and AOL), the Electronic Frontier Foundation (a non-profit public interest group promoting freedom of expression on the internet and initially funded by Mitchell Kapor, the founder of Lotus Development Corp. and Steve Wozniak, co-founder of Apple Computers) and the Boston Consulting Group. This corporation has established a set of practices with respect to user privacy that an online firm wishing to display the TRUSTe "trustmark" must adhere to and performs an audit function for continued use of the mark. These practices can be summarized as:

1. The firm must have a privacy policy governing how it collects, stores and uses information from website users
2. The firm must disclose this policy to website users by posting a privacy statement on its website
3. The firm must give users choice over what information is collected and how it is used (for example, seeking permission to distribute email addresses to other firms)
4. The firm must have in place security procedures that protect the privacy of information (including encryption of personally identifiable information such as social security or credit card numbers)
5. The firm must have mechanisms in place to ensure the accuracy of the information held by the firm, including means by which users can verify and correct the information held about them.

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<sup>43</sup> Seal programs such as VeriSign's are sufficiently new that it appears that seal providers have not yet fully implemented the consumer side of the equation. Advertising the seal to consumers will be essential as these systems develop.

Firms that have met and continue to meet these criteria can post the TRUSTe seal on their website. A user who clicks on the website is taken directly to the firm's privacy statement on their website. On that webpage, the firm must also post a "click to verify" seal that will take the user to a verification page on TRUSTe's secure server, ensuring that the seal is authentic and valid. Once on the TRUSTe site, users can also learn about how the TRUSTe system works.

TRUSTe enforces compliance with the privacy policies established by firms through at least three means. First, it monitors compliance by conducting reviews and by "seeding" websites: submitting unique user information and then tracking these identifiers to assess how they progress through the firms' system. Second, it conducts a dispute resolution process, in which TRUSTe seal subscribers must participate, to handle complaints from website users who feel that a site has abused their private information. Third, it maintains a "watchdog" service, whereby online users can report violations of privacy policies, misuse of the TRUSTe seal or other privacy concerns. These reports are then available for review by users at the TRUSTe website. Here the fluid relationship between technology (seeding), reputation (watchdog services) and a private legal regime (rules and procedures governing seal revocation and dispute resolution) is evident.

The internet has thus far focused attention on resolving the commitment problems that arise in unique fashion in e-commerce. Verifying the identity of a virtual trading partner has an analog in real space, but is in many ways a fundamentally "internet" challenge. Privacy is a concern in traditional commercial environments, but it takes on substantially greater significance in the internet environment both because of the ease of transmission and because of consumers' lack of familiarity with this environment. What

stands just around the corner, however, are commitment problems that have been around as long as commerce has been: performance and quality.

This move has been made within the past few months by what stands to be one of the more important seal programs for e-commerce: the WebTrust program offered by the American Institute of Chartered Public Accountants and Canadian Institute of Chartered Accountants. AICPA/CICA have established procedures to license CPAs and CAs to audit the business practices of an online firm with respect to privacy, security and the handling of consumer quality and performance complaints. Firms that have obtained an unqualified report from a CPA or CA holding a WebTrust business license will be issued an Enrollment Identification by AICPA or CICA (or another association licensed to approve WebSeal enrollment). Using the EID, firms then can then apply for certification with a “seal manager” (currently VeriSign Inc. but potentially any number of other private companies) which has agreed to manage the WebTrust seal. The manager will then issue a digital certificate that links to the WebTrust seal placed on the online firm’s website. Clicking on the seal will take the user to the certificate and the accounting practitioner’s report and to verification that the seal is authentic and valid. Periodic audits, the frequency of which is determined by the practitioner who issued the initial unqualified report, are then conducted by the accounting professional to ensure ongoing compliance with the WebTrust principles and criteria. These principles are:

1. *Business and Information Privacy Practices*: The entity discloses its business and information privacy practices for e-commerce transactions and executes transactions in accordance with its disclosed practices
2. *Transaction Integrity*: The entity maintains effective controls to provide reasonable assurance that customers’ transactions using e-commerce are completed and billed as agreed.

3. *Information Protection*: The entity maintains effective controls to provide reasonable assurance that private customer information obtained as a result of e-commerce is protected from uses not related to the entity's business.<sup>44</sup>

Firms operating online under the WebTrust seal must, among other requirements, have in place a mechanism for handling consumer complaints about any aspect of a transaction. They must also agree to submit to a third-party dispute resolution process approved by WebTrust in the event that a consumer is not satisfied with the company's handling of a complaint. This is a binding arbitration process that can be conducted online.

WebTrust developed the criteria for dispute resolution processes with The National Arbitration Forum, a private organization offering arbitration services. Although WebTrust may approve the use of other providers of arbitration services, these providers must adhere to the criteria NAF helped establish. Among these, it is important to note, is NAF's distinctive commitment to arbitration according to the public law of the relevant jurisdiction for a complaint.<sup>45</sup>

Other developments to promote commitment and trust in e-commerce are emerging on almost a daily basis, demonstrating the wide diversity of institutions and structures that the internet makes possible. Online auctions such as e-Bay and Amazon.com, dealing with the problem of fraud among an extraordinarily diffuse set of buyers and sellers, are innovating insurance, reputation mechanisms, dispute resolution processes, certification and bonding and escrow devices. Third-party providers are also

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<sup>44</sup> AICPA/CICA, WebTrust Principles and Criteria for Business-to-Consumer Electronic Commerce, Version 2.0 (October 15, 1999). Available online at [www.aicpa.org](http://www.aicpa.org) and [www.cica.ca](http://www.cica.ca).

<sup>45</sup> See for example NAF's leading pitch on their website: [www.arb-forum.com](http://www.arb-forum.com): "All arbitration is not the same. The Forum is a nationwide network of former judges, litigators and law professors who share the Forum principle that disputes should be decided according to established legal principles."

emerging to perform these functions, independently and in partnership with the online auction companies themselves. e-Bay, for example, has established a pilot-program partnership with a start-up provider known as SquareTrade.com, which provides online mediation and dispute resolution for consumers and auction-users.

On-line providers are also generating mechanisms to extend the power of the internet to exchange information and hence affect a firm's reputation to traditionally based firms. iLevel.com, for example, operates a website where consumers can register (at no charge at present, in the future probably in exchange for a per-incident or annual fee) a complaint against a company. iLevel then conveys the complaint to the company and gives the company 30 days in which to respond. If the complaint is resolved to the consumer's satisfaction in that time, iLevel posts the complaint and the company's response (if any) on its website. Other consumers can then visit the website to check out a company's history of complaints and also post their own comments on the dispute.

Websites such as iLevel offer a service to companies as well, providing a repository for an organization to track consumer satisfaction and opinion. Other services, such as eWatch provide more extensive monitoring services, tracking a company's on-line reputation in thousands of locations in cyberspace including the online media, chat rooms and bulletin boards. eWatch offers a further service, CyberSleuth, which will attempt to investigate the source of negative online statements about a company and recommend appropriate action (such as reporting false statements or the abuse of a system to a website or internet service provider which has the power to block access by those misusing a site or online communication.)

These cyberspace innovations help us to see much more clearly the relationship between technology, organization, reputation and legal regimes. What these innovations demonstrate is that there is substitutability between these alternative ways of providing the essential “glue” for commercial relationships: commitment. More specifically, they demonstrate the potential for a *private* legal regime to close up many of the gaps remaining after technology, organization and reputation mechanisms have shaped the incentives to and feasibility of default on the commitments that support a commercial transaction.

The extent to which these private regimes are able to “close the loop” without recourse to public law (as is largely the case for domain name disputes and seal programs such as BBBOnline and TRUSTe) is yet to be seen. Whether, for example, WebTrust’s recourse to an arbitration model which emphasizes the use of existing public law will remain stable, or whether it will be supplanted by competitors who offer private legal regimes that offer preferable solutions is something that will be determined in these markets. Provided, of course, that the public regime does not step in and supplant these private developments.

#### **IV. The Rationale for Privatizing Commercial Law: From Transactional to Organizational Regulation**

Whether it is wisdom or pragmatics, public law has simply not kept pace with the extraordinary rate of innovation and development on the Internet. There is an extremely good case to be made for keeping public law to an absolute minimum in the development of e-commerce, namely the tremendous benefits that can be derived from allowing experimentation and market innovation in this field to continue to teach us, as it already

is, what the role for public commercial law really is.<sup>46</sup> In what follows, however, I turn to the more generic case to be made for facilitating the devolution of commercial law as a whole into private market regimes. I have termed this a shift in the role of public law from transactional regulation to organizational regulation.

My starting point is the question, why should the state play a direct and substantive role in the development of the legal rules governing commercial relations? Why shouldn't the role of the state be to structure the conditions favorable to the development of efficient private governance regimes for commercial entities, much as the role of the state is to structure the conditions favorable to the development of efficient private mechanisms--ie. markets—for the production and distribution of goods and services? The history of private commercial legal regimes in the merchant courts and the extraordinary development of private legal regimes in cyberspace tell us that the concept of private commercial law is not an oxymoron, as some understandings of law seem to suggest.<sup>47</sup> Even if the state's monopoly on the exercise of legitimate coercive power is definitional of the state, this does not imply that the state must exercise a monopoly over the development of the substantive and procedural rules according to which that coercive power will be exercised.

The state could, for example, have a commercial contract law that read as follows:

*“All commercial entities entering into a contract must select a private provider of legal*

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<sup>46</sup> For another call to refrain from regulation of the Internet in order to put existing regulatory models in telecommunications and essential facilities access under fresh light see Glen O. Robinson, *Regulating the Internet*, [www.legalesays.com](http://www.legalesays.com) (1999).

<sup>47</sup> The law on arbitrability, for example, rests on a notion that arbitration's legitimacy derives from the fact that it defers to the state as the source of substantive law. See *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth Inc.* 473 U.S. 614 (1985). Some legal scholars are now advocating that arbitration should be subject to increased levels of review in the public courts, in order to ensure that the substantive basis for arbitration outcomes is in line with public law. See Ware, *supra* n.\*.

*rules to govern that contract. In the absence of a designation, the contract will be enforceable in the private legal regime chosen by the initiator of any claim under the contract. All orders, including subpoenas and final judgments, emanating from a private legal provider will be enforced by the state court and treated as final and not subject to review in the state court.*” Such a law would go further than existing law, which permits private legal regimes (such as those studied established by trade associations) to operate; it would remove the state from the field of providing a commercial law regime and thus relegate commercial parties to the use of private regimes. It is this form of “privatization” that I believe modern democratic societies should be pursuing.

Although I wish to leave this point open for refinement at a future point, it is at least initially clear that the state’s monopoly over the creation and implementation of personal law—the law governing the structure of democratic institutions, the preservation of social order and social harmony, the protection of individual rights and the nature of the relationships among citizens and the entities of civic society—is rooted in the normative basis for democratic society itself. The legitimacy of the state’s coercive power over its citizens is derived from its obligation, ultimately constitutional, to exercise that power subject to the set of principles definitive of that state. The state is, by definition, the source of the public law that defines the relationships of the citizens of that state.

Commercial entities are not citizens of the state. They are organizational structures; they are instruments through which individuals seek their goals. But as the fiction of the “corporate personality” recognizes, there is instrumental value in treating organizational structures as entities separate and distinct from the individuals who

populate them. This instrumental move does not, however, invest these abstract entities with political status; it does not make them citizens of the state. As a result, whereas it would deprive a citizen of their status as citizen, and thereby delegitimize the state, for the state to withdraw from its ultimate role in developing and enforcing the substantive law governing the relationship between the citizen and the state, privatizing commercial law does not implicate the legitimacy of the state. The question of whether to privatize commercial law is therefore an instrumental, not ontological, one for democratic societies.

The instrumental rationale for privatizing commercial law is based on the distortions that result from the state's exercise of monopoly over the production and distribution of commercial law. As with any monopoly, the absence of competition implies that the costs of commercial law are higher than they would be if private regimes were able to compete. Perhaps more importantly, the evolution of commercial law is governed not by market incentives and innovation, but by bureaucratic imperatives. It is overseen by a monopoly of providers, namely the legal profession. It is shut off from the potential for entrepreneurial developments that could lower the cost and increase the value of the legal regimes governing commercial relationships.

The public legal regime does a particularly poor job of achieving optimal legal complexity.<sup>48</sup> Indeed, the public regime is not even set up, as a hierarchical structure, in such a way as to attempt to achieve optimal complexity. The rules of engagement in our adversarial legal system are that the decisionmakers are obligated, in the first instance, to attend only to the information presented to them by the parties to a particular case at bar

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<sup>48</sup> I discuss the obstacles to optimal legal complexity more fully in "The Price of Law".

and to decide the case with a view only to implementing the relevant legal rules as accurately as possible. Because the common law evolution of legal rules fuses adjudication with rule changes through precedent, then, increasing complexity is not something to which the system, as a whole, can attend. It is not a legitimate legal reason to refuse to reach a result that the court *agrees* is a more accurate interpretation of the governing legal rules in a case on the ground that to do so would introduce a level of complexity that, in future cases, will yield fewer benefits than costs. The costs and benefits of legal complexity can be weighed only if the governing rules themselves direct attention to such instrumental considerations. Few do. The governing principles for due process, for example--which are ultimately constitutional--do not. In an important sense, our public legal norms place an infinite value on accuracy, coherence and consistency in the application and development of legal rules.

A private entity providing a legal regime under competitive market conditions, on the other hand, faces an incentive and can establish the organizational flexibility to optimize the level of complexity in its rules. Prior to the creation of a cooperative relationship and the existence of a dispute, commercial entities seeking to “purchase” a legal regime face a common interest in selecting a regime that achieves the goal of optimizing commitment and default costs: balancing the cost of the regime against the benefits measured as the gain from increased confidence in the cooperative behavior of other commercial entities. It is true that once a relationship and dispute are in place, commercial entities face strategic incentives to cheat and hence are more interested in a set of rules that benefits them at the expense of others. But this is a familiar collective action problem: *ex ante* all players are better off with an efficient set of rules, even if *ex*

*post* the interests of the players diverge as some seek inefficient, but privately beneficial, outcomes. Private legal providers face incentives the public commercial law regime does not to devise optimal solutions to this collective action problem. The essence of competition here is that if a given solution is or becomes overly complex, it is subject to losing business to a competitor provider.

We do not have to rely only on economic theory to support these claims. The best evidence of the ways in which public commercial law deviates from the commercial law that would develop in markets is found in those places where it has emerged. The private legal regimes in trade associations, for example, are remarkable for the ways in which they differ from the public regime: they do not develop rules through adjudication; the rules they do put in place tend to be simple and stable; and they use complementary mechanisms, such as reputation and expulsion from the association, to supply the commitments necessary to support their commercial contracting relationships. The nascent regimes on the Internet show similar traits. ICANN's regime for resolving domain name disputes, for example, consists of simple rules; adjudication by competitive dispute resolution providers; a separation between rule making and rule application (as embodied in the fact that the adjudicators have no authority to establish precedent and do not publish extensive reasons for their decisions)<sup>49</sup>; procedures that do not require in-person hearings and do not apply the public law rules of evidence; and remedies that are clear and limited in scope.

It is particularly interesting to see the *proportionality* in these mechanisms between the value of the interests at stake and the cost of the procedures to which

disputants are “entitled”. This is what economic theory would predict as a market result: a move to rules that are optimal in light of the costs of the rules. It is precisely what is missing from the bureaucratic development of rules in the public law system, where the costs of procedures are largely ignored (as a matter of judicial principle) and the value of the rights at stake treated as absolute (which is arguably correct in terms of the legitimacy of the state and its courts). It is far too early to say, of course, what the equilibrium characteristics of the private legal regimes developing on the Internet will be. But it is possible to see quite clearly in this model the impact that an available public regime can have on the development of private regimes.

The proliferation of legal regimes on the internet, supplying legal needs not unlike those that can be identified in traditional commercial environments but for which parallel private regimes have not emerged, suggests first that public law can “crowd out” private law development. That is, where public law is available, it is difficult for private regimes to compete. This could be for at least three reasons. First, any legal regime will exhibit network externalities: the more users in the regime, the greater the benefits of being a user. The vastness of the public regime thus presents a significant barrier to entry to private providers. As a system that has developed over hundreds of years in millions of cases, the public regime has “answers” to a great majority of questions—except questions on the cutting edge of commercial development. The price of this extensive system of “answers” however is the complexity and expense of the public regime. This is the margin on which a private provider can compete; but it must do so sufficiently to overcome the network benefits of the public alternative.

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<sup>49</sup> Dispute resolution providers under ICANN’s domain name dispute policy are required to publish their

Another way of thinking about the barrier to entry posed by the public legal regime is in terms of switching costs. Users of the public regime, through their lawyers, have invested in learning the content and behavior of the public regime. This is the, increasingly substantial, value of experience and specialization in law.<sup>50</sup> Switching to a new regime, which will require new investments in learning and experience, is costly. The public regime, therefore, locks in “customers”, making it difficult for private entities to compete.<sup>51</sup>

A second entry barrier to private provision of legal rules arises because of the durability of the public regime. Twenty years from now, the public regime will still be around to adjudicate cases. It is harder for private entrants into the market for legal regimes to offer users the same level of confidence that they will be around when a dispute arises. This is not to say that private mechanisms for creating durability could not develop; this is not to say that the value of durability trumps all other values and hence outweighs the gains that private innovation in legal regimes could offer. But it is to say that the durability of the public regime may prevent private regimes from ever getting started, even if once started they could evolve to the point at which they could compete effectively with a durable public option.

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decisions. See [www.icann.org/udrp/proceedings-list.htm](http://www.icann.org/udrp/proceedings-list.htm) for a list of pending and resolved disputes.

<sup>50</sup> See the discussion in *The Price of Law* at \*\*. The increasing importance of experience in legal practice is implied by the increasing complexity of law and empirically shown by the increasing rate at which legal fees and earnings increase with specialization (analysis of Altman Weil data on file with author) and the increasingly specialized nature of legal practice (see Heinz *et al.* “The Changing Organization of Lawyers’ Work” *supra* n. \*).

<sup>51</sup> The presence of network externalities is an important reason for path dependence—and potential long-term suboptimality—in the evolution of institutions. See generally North, Institutions, *Institutional Change and Economic Performance* (1990); Anderson, Arrow and Pines *The Economy as an Evolving Complex System* (1988). Brunet, *supra*, assumes that the market for dispute resolution mechanisms is essentially competitive in presenting the argument that the judicialization of arbitration reflects the demands of sophisticated customers. My argument here is that this market is in fact not competitive in the sense that providers that fail to meet the changing demands of users are not subject to significant loss of market share.

A third obstacle to the emergence of private legal regimes is more fundamentally legal. The public regime, because it remains in the field, can ultimately trump private regimes. As we have explored already, establishing a private regime with public law in the background—through contract and agreements to—ultimately rests on the public law governing contracts and arbitration.<sup>52</sup> This has an important impact on the potential for entrepreneurship because it ties any private developments quite tightly to public law providers. Users and providers of a private regime need to know the ultimate public legal meaning and status of their private system. For this, they need lawyers and a design that has a carefully drawn public law interface. This implies substantial constraints on the development of private regimes. Such regimes will inevitably replicate the public regimes for a variety of reasons ranging from technical requirements imposed by the public law and the role of lawyers’ legal training and values (including professional self-interest).

Consider for example the competition between lawyer and non-lawyer mediators. Only lawyer mediators can bundle together with their mediation services (and hence at lower cost) legal advice and opinions about the likely interpretation and enforceability of the provisions in a mediated agreement. The same is true, even more so, for arbitration, where results are subject not only to interpretation by the courts, but regulation in the form of arbitrability doctrine. Not surprisingly, the evolution of these “alternative” forms

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<sup>52</sup> Ware, *supra* n, for example, presents a cogent argument as to why the public law must either review arbitration decisions based on mandatory legal rules (that is, those that may not be waived by contract) for legal error or declare such subject matter inarbitrable. While this makes sense, it makes clear the need for detailed legal advice—specifically the contours of what is mandatory and what is not—in the design of a private legal regime with the public regime of contract and arbitration law in the background.

of dispute resolution has been away from a distinctive regime towards a system that is increasingly indistinguishable from traditional litigation.

The development of domain name dispute resolution under ICANN will be something to watch from this perspective. At its starting point (which is only a few months ago), the regime shows the potential for substantial independence from the features of the public legal regime: the rules and procedure are stated in fairly simple terms, the process is tailored and abbreviated in a way that seems appropriate to the issues at stake, and the resolutions are capable of being offered in brief form by competing private providers without fusing adjudication with rule development.

There are two shadows over this system, however. One is that the private providers of the adjudication function (three have been accredited thus far) are currently populated by members of the legal profession. NAF's arbitrators in this area are all retired judges. eResolution/dispute.org's and WIPO's arbitrators are all lawyers and law professors. This creates a likelihood that lawyers' ways of thinking—which are the public regime's ways of thinking, including the conflation of commercial and personal norms—will drive the evolution of these systems. This “cultural risk” has been recognized for sometime in the area of securities arbitration, where the exchanges commit to having only a minority of arbitrators from the securities industry on a panel deciding a dispute between the exchange and a customer. The recognition of the risk may also be informing the development of nascent services such as SquareTrade.com, where it appears that the mediation providers are predominantly non-lawyers.

The second shadow on the development of ICANN as a private legal regime is cast by the public law of trademark and unfair competition. The as-yet unanswered

question is whether or not a simple system of resolving domain name disputes can flourish without having disputes drawn off into the public courts under trademark actions. At some point, perhaps already, one suspects that corporation lawyers will be advising their clients to file trademark actions in the public courts to obtain the transfer of a domain name, with the potential for shifting the entire process out of the private regime. The UDRP explicitly provides (although it is formally redundant given the overriding authority of the public law in this area) that a domain name will be cancelled or transferred on receipt of a court order requiring such action.

These risks are not unrelated. The lawyers involved in deciding domain name disputes have already, in their first decisions, shown the capacity for law to breathe complexity into the small number of relevant concepts governing dispute resolution. The ICANN rules, for example, indicate that names are to be allocated on a first-come-first-served basis unless the first registrant has registered and is using the domain name in bad faith.<sup>53</sup> The early opinions (particularly those coming out of WIPO—the least market-oriented of the three providers) are already parsing in detail what it means to “use” the domain name.<sup>54</sup> If the process continues down this road, it will only be a matter of time before the content of these terms becomes woven with cases and legal reasoning from the domain of public trademark law. As it does, it will drive a wedge between the public and

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<sup>53</sup> More precisely, the complainant has to show that the domain name is identical or confusingly similar to complainant’s trademark(s), the registrant has no legitimate interest in the name and that the name has been registered and is being used in bad faith. ICANN, Uniform Dispute Resolution Policy, Paragraph 4(a).

<sup>54</sup> See, for example, the WIPO decision in connection with the transfer of the domain name telstra.org from Nuclear Marshmallows to Telstra Corp., *supra*. Telstra is the largest company on the Australian stock exchange. Nuclear Marshmallows is nowhere registered as a business and the Administrative Panel was unable to contact anyone purporting to “be” Nuclear Marshmallows to respond to the complaint. The decision, which goes into elaborate analysis of the significance of the word “and” and the use of both the past and present tense in the phrase “has registered and is being used”, is painful to read, and more than a bit embarrassing to the legal profession.

the private regime, with the public regime offering the “free ride” on the body of precedent established by the work of the public courts. The wisdom of a “start-up” competitive provider, committed to a less turgid dispute resolution process, is highly dependent on whether the public regime is truly able to substantially withdraw from competition for the field. Where lawyers rush in, entrepreneurs fear to tread.

The principal rationale for privatizing commercial law is that, as in any other area of social organization, the provision of a service by a single provider brings costs. In some cases those costs are secondary, or clearly balanced by the benefits. But the burden at this point in the development of democratic market societies should be on demonstrating why the costs of monopoly provision and bureaucratic development should be shouldered. In the area of commercial law, the reasons are far from apparent

This is not to say that there is *no* role for the state in commercial law. The private, competitive system for registering and resolving disputes about domain names depends, critically, on some minimal public law conditions: most importantly, the exclusive authority of ICANN to assign access to the root server system and a public obligation on NSI to implement the Shared Registration System so that competition in registration can emerge. The role of the state is to provide organizational regulation: the public legal ‘infrastructure’ necessary to facilitate the emergence and competition between private providers of law.

The analogy is to the role of law in the production and distribution of goods and services in a market economy. Markets cannot emerge and remain competitive without a basic legal structure. Optimal legal rules do not allocate goods and services directly; this would be transactional regulation. Instead, they permit and constrain the development of

institutions and markets that coordinate incentives for efficient production and allocation: organizational regulation. The privatization of commercial law takes this a step further and looks to public commercial law not for the substance of commercial legal rules, but rather for the rules necessary to allow private entities to act as the providers of efficient legal rules.

## **V. Principles for privatization: Creating a truly private commercial law regime**

From the Middle Ages to the Digital Age, there are a number of lessons to be drawn about what commercial relationships require in terms of law in order to flourish and how private, as opposed to public, institutions might supply that law. The project of privatizing commercial law is, of course, a very large one. As the examples discussed above indicate, the rationale and scope for privatization may vary from setting to setting. Contracts between commercial entities, for example, where the parties are known to one another and disputes that will arise come within the scope of a negotiated agreement raise different issues for privatization than does intellectual property protection, where legal rights have implications for third-party entities who are not in a contracting relationship. And, although some of the most fascinating developments in Internet dispute resolution involve consumer protection and suggest a potential for privatizing some aspects of law in this area, the rationale I am exploring in this paper is confined to the legal relationships between commercial entities.

The process of privatizing commercial law is therefore something that will have to be developed area by area, with careful attention to both the structural attributes of and the normative considerations relevant to the relationships to which a particular area of commercial law would apply. The lessons from the medieval guilds, the trade

associations, and the Internet, however, suggest a set of principles that can guide this process of rethinking the role of private and public institutions in supplying law.

*1. The cooperation that creates value in commercial relationships requires mechanisms for communication, coordination and commitment.*

Cooperation—from a simple agreement to trade to the creation of intricate structures such as corporations or joint ventures—is the source of economic value in commercial relationships. Through cooperation, entities reap the gains from trade, from synergy and from both tangible and intangible forms of exchange arising from the differences between them in terms of assets, location, knowledge and so on. In order for cooperation to occur between entities, however, essential relational mechanisms have to be available. These entities need a means of communicating and sharing information to identify each other and the possibilities of valuable cooperation, both at the initiation of their relationship and as it progresses. They need a means of coordinating their activities, particularly their responses to information, in order to reap the benefits of cooperation. The medieval merchants, for example, could not have developed long-distance trading relationships without a means of communicating and coordinating with the buyers in foreign lands. The medieval fairs were a mechanism for communication and coordination of these (from a modern perspective, relatively simple) trading relationships. The expansion of the volume of long-distance trade was facilitated by the development of another relationship which reduced the costs of communication and coordination: the relationships between merchants and their agents, who traveled to the fairs at lower costs and so reduced the costs of using these mechanisms of communication and coordination. The communication and coordination necessary to support the agency relationship was then a relatively simple matter of local and personal contacts.

For these relationships to develop, however, merchants and agents needed assurance that each would perform their part of the arrangement. Cooperative arrangements create vulnerabilities: one party acts before the other, valuable information is shared, access and control over assets is granted. In some relationships, usually personal in nature, the confidence to proceed with a cooperative arrangements comes from the social and ethical norms and practices of the community in which the relationship is embedded: altruism, benevolence, trust. These norms and practices give cooperating parties a reason to believe that their vulnerabilities will not be exploited; where these norms are stable, these beliefs are rational and they make going forward with a cooperative relationship rational.

For commercial relationships to reap the benefits of moving beyond personal communities secured by social practices, however, commitment mechanisms are necessary. A commitment mechanism gives cooperating entities a rational basis for believing any vulnerabilities they will expose through cooperation will not be exploited.

2. *Commitment can be provided by reputational, technological, organizational, and legal means.*

Commitment—a rational basis for relying on the other entity in a cooperative relationship—can come from a variety of mechanisms other than the personal and social practices of trust, benevolence and so on. These can be organized in four categories.

*Reputational mechanisms:* A reputation mechanism secures commitment by creating a (credible) threat that an entity that fails to live up to its part of a cooperative arrangement or which exploits the vulnerabilities of its cooperative partners will face a loss of future benefits because of damage to its reputation among potential cooperative partners. The mechanism devised the medieval guilds is an example of a reputation

mechanism. The guilds established a reputation mechanism by collecting and publicizing the information about any defaults on the part of merchants or rulers in trading relationships and by coordinating the punishment for default: guild-wide embargoes on trade for defaulting rulers in foreign lands and loss of trading rights for defaulting merchants and agents, including those who failed to cooperate in an embargo to punish a wayward ruler.

A reputation mechanism can also work on a one-on-one basis in some cases, where the withdrawal of future cooperation by partner is sufficiently costly to give the other partner a reason not to cheat. The circumstances in which this mechanism will work have been carefully examined by both theoretical and empirical game theorists.<sup>55</sup> The key to “working” is that the threat of withdrawing future cooperation has to be credible. This is in and of itself another commitment problem, and one that can potentially be solved a different commitment mechanism.

*Organizational mechanisms:* Indeed, one of the important things to recognize about various solutions to commitment problems is that, very often, they do not *eliminate* the commitment problem; rather they *transform* the commitment problem into another form, one that can be more easily or less expensively resolved. The medieval guilds transformed the commitment problem facing many individual merchants in their relationships with foreign rulers and agents to a commitment problem facing the guild as a single organizational entity.

This shift in the locus of the commitment problem is an example of an organizational mechanism, namely the creation an organizational structure (a set of

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<sup>55</sup> For an overview, see []

relationships) which faces different incentives and has different assets, knowledge and other characteristics with which to secure commitment. An organizational mechanism could, for example, shift the commitment problem to an individual who is able to give assurance on the basis of a social practice or norm. This transforms a problem with its origins outside of a personal community into one which can draw on the beliefs that members of a community have in the reliability of one of their members. A personal guarantee from a respected and trusted person is an example.

In some cases, the commitment power of the organizational shift will come from the fact that the individual or entity to which commitment is shifted can make use of a reputation mechanism to provide the necessary assurances. This is evident in a number of the developments on the Internet. In CPA WebTrust, for example, the governing professional bodies for accountants in Canada and the United States undertake to license individual members of their profession to monitor and enforce the commitment of individual entities to disclose and abide by their on-line privacy, security and consumer satisfaction practices. This organizational mechanism shifts the locus of commitment from potentially hundreds of thousands of online entities to a single entity: the professional association. This entity has a valuable reputation to protect; failures to live up to its part in the cooperative arrangement would be costly to the profession as a whole. Indeed, the accounting profession is responding aggressively to commitment problems in cyberspace by redefining itself as being in the generic “assurance” business, rather than the bookkeeping and financial auditing business.<sup>56</sup>

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<sup>56</sup> See CPA WebTrust statement of certification practices, October 15, 1999.

In other cases, the organizational mechanism generates commitment because it creates a relationship which simply does not give rise to the same set of incentives for cooperational defaults. A for-profit stock exchange, for example, faces financial incentives to enforce its rules because the rules increase the value of trades on the exchange and thus increase any transaction or membership fees the exchange can charge. In a very different setting I have looked at how an organizational structure that delegates pricing decisions to small retailers instead of a large oligopolist—which is the structure in some franchise systems—can secure a (publicly detrimental) commitment to a threat to meet entry with price-cutting.<sup>57</sup> Conversely, vertical integration is an organizational device that internalizes, and hence transforms, commitment problems arising in a supply relationship, particularly those in which one or both parties makes idiosyncratic investments.<sup>58</sup>

In all these different ways, an organizational mechanism shifts commitment problems to entities facing different incentives and manipulates the incentives to achieve those that pose fewer or easier-to-solve commitment problems. Sometimes these solutions show tremendous organizational ingenuity. Sometimes it can be as simple as I cut the cake and you choose your piece first.

*Technological mechanisms:* The developments on the Internet demonstrate with a certain elegance another mechanism for transforming the nature of a commitment problem: technology. A technological mechanism attacks a commitment problem by

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<sup>57</sup> Gillian K. Hadfield “Credible Spatial Preemption through Franchising.” *RAND Journal of Economics* Vol. 22, pp. 531-543 (1991).

<sup>58</sup> There is a vast literature on the problem of opportunism and organizational structure. See generally Paul Milgrom and John Roberts *Economics, Organization and Management* (1992); Oliver Williamson *The Economic Institutions of Capitalism* (1985) and Oliver Williamson *Markets and Hierarchies* (1975).

fundamentally restructuring what cooperating partners can do and at what cost. The public key infrastructure being implemented on the web, for example, allows online entities that are sharing data (credit card numbers, strategic planning documents) to reduce the risk (increase the cost) of unauthorized access to this data by encrypting it. The promise to maintain confidentiality is transformed from a costly problem of controlling access to data transmissions over the internet to the less costly problem of controlling access to private encryption keys.

Technology has also played a role in the resolution of the commitment problem facing the development of a competitive domain name registration process. Formally a monopoly, Network Solutions Inc. is now obligated by contract to act as a central repository for the registration of domain names by a hundred competitive firms, one of which is NSI itself. Much of the commitment problem arising here is resolved by the technology of the Shared Registration System, which can allow the checking of domain name availability and the registration process to be automated and hence eliminating the need (and hence scope) for NSI active participation in individual registration transactions. Oversight of NSI, then, reduces to ensuring that the SRS is not corrupted.

In another ingenious example, the commitment power of a computer algorithm delivered over the internet is being marketed by a private online entity, clicknsettle.com, to facilitate negotiations over dollar figures in an unlimited range of settings. Negotiating parties can sign onto the clicknsettle.com and commit to an automated negotiation procedure. The bids are monitored by the software on the clicknsettle.com website and if the bids come within 30% of each other, the algorithm delivers an agreed price which splits the difference. This process allows negotiating parties to attempt to reach

agreement without revealing bids, and hence information, to each other. This preserves the value of any private information in the event there is no settlement, meaning that the act of negotiation itself does alter either parties' position. It also decreases the scope for strategic bidding and hence the cost of a negotiation to one or both parties.

*Legal mechanisms:* Finally, after the possibilities of reputational, organizational and technological mechanisms have been explored and implemented fully, partially or not at all we have legal mechanisms. Legal mechanisms are rules, both substantive and procedural, which seek to control the conduct of cooperating parties through edict and enforcement, ultimately backed up by the state's monopoly on the legitimate exercise of coercive power. Legal systems, public and private, establish a mechanism whereby penalties are attached to conduct that an adjudicator finds to be in violation of the rule. These penalties alter the incentives, and hence potentially the conduct, of those subject to the mechanism.

In the public legal regime, the state determines who will be subject to the mechanism through its substantive jurisdictional rules. In private legal regimes, the state also determines jurisdiction, but does so indirectly by treating the orders emerging from the legal regime as valid and sufficient to invoke the coercive enforcement of the state. The state's substantive involvement may be absolutely minimal, with no inquiry into the substantive or procedural attributes of an order. Alternatively, the state may take a range of increasingly substantive roles: reviewing the extent to which the private legal entity has acted within a contractual or legislative grant of authority, adhered to its own procedural rules and/or reviewing the substantive approach taken in arriving at the order.

The public law regime contains examples of these varying degrees of review. Lower courts do not review the orders of higher courts; they just enforce them. Appellate courts review the procedures and legal determinations of lower courts but do not disturb factual conclusions except on narrow grounds. The decisions of government agencies are reviewed by courts for compliance with required procedures; the substance of an agency decision is reviewed to an extent that is itself subject to common law development. The judgments of foreign courts are enforceable in some cases without any review, as is the case for out-of-state orders<sup>59</sup>, in other cases with only minimal review, as is the case with orders from foreign legal systems that look like those of the enforcing state<sup>60</sup>, and in other cases with de novo review, as when the orders emanate from systems that the enforcing state believes do not meet minimal standards.<sup>61</sup>

The range of possible legal mechanisms, therefore, allows for varying degrees of public law: from an absolute minimal public law component restricted to the registration of private legal judgments as publicly enforceable orders to a complete preemption of the field by public law. Within these extremes are regimes in which public law plays a role

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<sup>59</sup> U.S. Const. Art. IV, s. 1 provides that out-of-state orders are to be granted full faith and credit in the courts of any other state. Out-of-state orders are not entitled to full faith and credit, however, if they were not obtained in compliance with basic due process requirements of the 14<sup>th</sup> amendment. See *Old Wayne Mutual Life Assoc. of Indianapolis v. McDonough* 204 U.S. 8 (1907), *Baker by Thomas v. General Motors Corp.* 522 U.S. 222 (1998).

<sup>60</sup> See *Hilton v. Guyot* 159 U.S. 113 (1895) (“ Where there has been opportunity for a full and fair trial before a foreign court of competent jurisdiction, conduction [sic] the trial on regular proceedings, after due citation of voluntary appearance of the defendant, and under a system of jurisprudence likely to secure an impartial administration of justice between the citizens of that country and those of other countries, and there is nothing to show either prejudice in the court, or in the system of laws under which it was sitting, or fraud in procuring the judgment, or any other special reason why the comity of the United States should not allow it effect, the merits of the case should not, in an action brought in this country on the judgment, be tried afresh, as on a new trial or an appeal, upon the mere assertion of a party that the judgment was erroneous in law or in fact.”)

<sup>61</sup> See e.g. *Bridgway Corp. v. Citibank* 201 F.3d 134 (2d Cir. 2000) (Judgment of Supreme Court of Liberia not enforceable in U.S. because of uncontradicted evidence that political upheaval had resulted in a failure of impartiality in tribunal).

in structuring the private mechanism, such as by providing criminal penalties for fraud or perjury to promote the effectiveness of a private regime that relies on disclosures from self-interested parties, or by setting restrictions on the rules according to which contracting or disputing entities select a private regime, or establishing minimal conditions or broad principles which private legal rules must meet.

3. *Private competition in markets will promote innovation and efficiency in the balance between these alternative means of commitment.*

Choosing a combination of commitment mechanisms to support a given commercial relationship is fundamentally an economic problem. Actual and expected failures of commitment—default-- are costly: when parties do not fully believe that their partners will do their part in a cooperative scheme, they protect themselves by reducing or hedging their investments in the scheme, expending resources on protecting their investments or private information, behaving strategically themselves, and so on. Commitment mechanisms are also costly; their costs are a function of the nature of the commitment problem in a relationship, and the mix of mechanisms adopted. The optimal mix of mechanisms is the one that minimizes the net costs of commitment and the residual risks of default.

This optimization problem has multiple layers. An optimal mix of mechanisms also requires that each mechanism be implemented in an optimal way. Holding constant the effectiveness of a mechanism in deterring defaults, the cost of a given mechanism should be minimized. A reputation mechanism should minimize the cost of collecting and transmitting information and coordinating punishments; it should use the least cost punishments that achieve the optimized level of deterrence. An organizational mechanism should be implemented to minimize the losses associated with any strategic

incentives or other transactional barriers it creates. A technological mechanism should be developed at lowest cost and subject to optimal levels of research and innovation.

An optimal legal mechanism is one that achieves effectiveness in deterring defaults on commitments at an optimized level of complexity: the trade off between accuracy (implementing the theoretical “intent” of the rules) and the cost of achieving accuracy. Optimal discovery rules, for example, limit discovery (theoretically) at the point at which the marginal benefit of increased information is equal to the marginal cost of obtaining that information. An optimal domain name dispute rule (such as the policy established by ICANN) balances the cost of achieving the goals of uniqueness, competitive registration and minimal strategic registration with the costs arising from procedure and (in future disputes) ambiguity or strategic invocation of these or jurisdictionally-related rules.

The problem of optimal complexity is itself such a complex one that it is particularly important to make as much use as possible of private market mechanisms in legal design. The optimal level of legal complexity is a function of the optimal mix reputational, organizational, technological and legal commitment mechanisms. This optimal mix is sensitive to a wide variety of parameters, varying across settings. It is also subject to change at a potentially rapid pace as the relative costs of these mechanisms vary in complex ways. One of the reasons the internet is showing such an explosion of private solutions to commitment problems is precisely the fact that the costs of these mechanisms are changing at the underlying rapid-fire pace of technological developments in the computer industry. The pace of public legal development is positively glacial in comparison and even if the public regime faced the incentives and developed the

organizational structure necessary to optimize complexity, it could not begin to keep up with the changes in the conditions determining optimality.

This is not to say that there is no role for the public regime in achieving an optimal mix of commitment mechanisms. Some commitment problems can only be solved or solved at reasonable cost by the public regime: criminal commercial fraud (intentional and systematic deception) may be an example. Public provision, however, comes at the cost of losing the benefits of market incentives to innovate and implement optimal commitment solutions, particularly in the face of rapidly changing conditions that alter the costs and benefits of alternative commitment mechanisms.

4. *The public value at stake in the balance between these alternative means of commitment in purely commercial (business-to-business) relationships is economic efficiency, not justice.*

Outside of the commercial setting, it is clear that there are functions that the public law must perform, not as a matter of optimality, but as a matter of democratic legitimacy. The rights of citizenship—the pact under which the members of a democratic polity agree to delegate power to the institutions of the state—must be the subject of public law or else they are meaningless. The right to vote, to be protected against discrimination, to privacy, to due process: the protection of these rights cannot be devolved onto private organizations without depriving persons of these rights qua democratic rights. Social order ultimately depends on public law, or the oversight of private entities exercising power to establish order. Whenever the interests of the members—the people—of a state are at stake, democratic legitimacy ultimately requires law to be public. The values at stake are those of democracy and justice.

The public value at stake in relationships between commercial entities—“artificial persons”—is economic efficiency. The rules governing commercial entities, until they

meet the point at which a personal interest arises, are instrumental to social welfare. Consequently, whereas there are reasons arising from democratic principles of justice for the public regime to retain lawmaking authority in the personal sphere, the only reason for public law to play a role in the provision of commitment mechanisms for commercial relationships (ie. those not involving real people) is that doing so promotes efficiency.

Although this is phrased as an assertion, it can be understood also as a guide to mapping the domain of privatization efforts. Where justice in a relationship is at stake, public law must ultimately govern for democratic reasons. Where efficiency in a relationship is at stake, there is a role for public law only insofar as public law promotes efficiency. Establishing the procedural rules for a corporation in a commercial contract dispute, for example, is a matter of efficiency which can be resolved by the market. Establishing the procedural rules for a corporate officer sued in his personal capacity is a matter of justice that must, ultimately, be resolved by democratic public law principles.

5. *The private provision of legal regimes cannot fully develop in competition with a public default or alternative regime.*

The existence of private legal regimes such as the medieval guilds, stock exchanges, trade associations and internet seal programs demonstrate that private legal regimes are feasible in the commercial sector. But they also demonstrate that private regimes are relatively rare. Private regimes appear to emerge only in settings in which public law is absent (such as in medieval Europe) or highly incomplete (such as in cyberspace). Even though law in many settings is not mandatory—contract law being the greatest example—it appears that there must be extraordinary value associated with a private legal regime (such as membership in the diamond exchange) before it can displace a default public regime. Curiously, for example, private commercial

arbitration—in practice and in legal theory--has moved away from the creation of substitute substantive rules and towards the motto: we apply *the* law.<sup>62</sup>

There are a few reasons to think that the public regime, even as a default regime, poses an obstacle to the flourishing of private legal regimes. Theoretically, the economies of scale, network externalities and durability associated with a public legal regime are a barrier to entry. Competing systems face a difficulty in getting off the ground and hence 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.

One practical way in which this manifests is that the public regime's monopoly, *de facto*, restricts the pool of potential innovators or private legal entrepreneurs. Where the public regime occupies even a default role, the design of private legal rules as a component in a commitment mechanism requires input and expertise from lawyers. As an economic matter, this creates a comparative advantage for lawyers to perform the role of developing "alternatives" to the system that creates their advantage. Quite apart from strategic incentives not to stray too far from the fold in the design effort, however, lawyers bring a distinctively *public* law perspective to the problems of commitment. This is how they are educated. This is how they identify themselves. This is how they

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<sup>62</sup> See Brunet *supra* n. 5

understand their job. As a result, lawyers tend to generate only marginal variations of public law; this is demonstrated with abundance in the arbitration models developed by lawyers. Nor, given the deference shown to lawyers and the non-lawyers' sense of low competence in "legal" matters, do non-lawyers tend to design private legal regimes. As a practical matter, the public regime, even as default, acts as a deterrent to private legal innovation.

6. *The role for the public regime in commercial law is to provide whatever public law is necessary to facilitate the emergence and competitiveness of private legal regimes, and to provide the coercive force necessary to make private law effective. This involves a shift from transactional to organizational regulation by the state.*

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 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 question to explore in privatizing commercial law is, therefore, to identify the points at which public legal structure is needed in order to facilitate the emergence and maintenance of efficient competition among private legal providers. Where is public law indispensable?

The introduction of competition into the markets for telecommunications and power in the past decade is an example of the application of this approach to legal design.

The efficiencies associated with a single power grid, for example, do not require a single power generator and distributor; unbundling generation and distribution services from grid services has allowed competition to prevail where it can and monopoly to remain where necessary. The regulation of public utilities has therefore shifted from transactional regulation (rate regulation) to organizational regulation.<sup>63</sup> Internet domain name registration implements this model also: locating minimal organizational regulation at the level of ICANN and NSI (requiring NSI to facilitate competition among domain name registration companies). The role for public law is to do what only public law can: provide the necessary organizational regulation to achieve efficient markets for private commercial law.

Some collective action problems arise in the market for legal regimes and so must ultimately be resolved uniquely by the public regime. Rules that optimally balance the interests of parties on both sides of a potential dispute, for example, may require public rules to overcome the incentives for capture by repeat or comparatively wealthy players. The value of uniformity in law may, in some cases, outweigh all other concerns and the potential for the benefits of uniformity to be privately dissipated by a commercial monopoly provider too great to justify private provision. 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.

As an example, made especially salient by the digital revolution, there is a need to ask what public legal rules would be necessary to permit competition among private

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<sup>63</sup> See Ronald Daniels *Ontario Hydro at the Millenium: Has Monopoly's Moment Passed?* (1996).

patent regimes. Would it be possible to allow competition to determine questions that are now vexing Internet developments such as the appropriate scope and length of patents necessary to support commercial innovation?<sup>64</sup> What would it take to ensure that private patent regimes did not compromise the public interest in efficient innovation, either by being responding disproportionately to the interests of patent holders and granting very long, capacious patents, or to the interests of patent challengers by failing to provide sufficient protection to warrant the expense of research and development of easily appropriable inventions? What type of intervention might be necessary to ensure that network externalities and economies of scale in the provision of a patent regime did not result in excessive concentration in the market for private patent law providers?

If public provision of patent law was a perfect implementation of the theory of efficient patents we would not need to ask these questions. But the public patent regime (as an example) is an imperfect institution. Any private regime that could be devised will also be imperfect. The question is therefore a comparative one. To make the comparison we need to ask the fundamental question, what must the public law do in this setting that private providers could not in order to promote the public interest in efficiency in commercial relationships?

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As the explosion of the internet makes plain, there is a critical need to open up the evolution of legal regimes to the creativity that, as a closed bureaucratically-driven structure, the existing legal system lacks. There is a critical need, and tremendous opportunity, to translate the dramatic changes in the cost of information into reduced

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<sup>64</sup> This area seems to be a particular mess. See Randall E. Stross "Patently absurd claims, Clueless courts

transaction costs for commercial relationships. Overcoming the stagnation of legal form and substance in commercial relationships requires that we break free of the hold that the 19<sup>th</sup> C has on the legal imagination. Looking back in time and through cyberspace, there are important guideposts to creating the legal regimes that can keep pace with the digital revolution. Privatization is the first task of commercial law in the Digital Age.

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and a broken patent system help Amazon” 128 *U.S. News and World Report* (March 20, 2000).