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## The Public and the Private in the Provision of Law for Global Transactions

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*The Public and the Private in the Provision of Law for Global Transactions*

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## **I. Introduction**

In a series of papers, I have discussed the potential and actual role for private profit-making entities to produce commercial law (Hadfield 2001, 2002, 2004, 2006). Like Bernstein (1992, 2001), I start with the premise that law governing commercial transactions need not be provided by the state—which is to say that the regimes that private parties develop to provide the commitment and coordination necessary to support their transactions are ‘law’—a point demonstrated in historical context most forcefully by Greif (1993, 2006). In this volume, three contributions raise interesting questions about the potential for private provision of law in global transactions, a setting beyond the boundaries of the state in which private provision of law takes on particular importance. On the empirical side, Dietz and Nieswandt, based on their study of software contracting between German customers and non-German suppliers, find little if any reliance on private legal regimes; Gersch and Welling, on the other hand, identify the use of private legal regimes in European internet transactions, specifically through the use of digital

certificates and seals (an example of a private legal regime that I have explored myself in Hadfield (2004).) On the theoretical side, Calliess challenges the capacity to distinguish, as a matter of both theory and practice, between a public and private legal regime, or between what I have called the economic and democratic functions of law, particularly in the transborder setting and urges recognition of the evolutionary process by which mixed public-private governance regimes generate transnational civil order.

In this essay, I revisit the public/private divide in order to explore more fully the potential for private production of law in global exchange and also to clarify what I think are differences in the way common law and civil legal scholars think about the public and the private in law. These differences stem, I believe, from the centrality of a crisp public/private distinction in traditional civil law theory and the far muddier distinction in common law. As a result, North American scholars such as myself use public and private to refer to a variety of legal dimensions and not only the one I take to be central in civil law. We do have the same starting point: as defined by Calliess (this volume), private law “concerns the relations between individuals” and “public law regulates the activities of the state in relation to the individual.” This is also a way in which common law scholars use the terms “public law” and “private law” but it is not the only way. In some contexts “private law” is defined not by the nature of the relationship (individual to individual or state to individual) but by the private entity status of a producer of legal rules and adjudication and enforcement services. “Private ordering” is also sometimes called “private law” but in this context “private” is defined not by the status of the legal regulator or the nature of the relationship governed, but rather by the source of the content of legal obligations: legal obligations based in private ordering derive

exclusively from the intent and consent of the obligated party to be bound. This latter use of the public/private distinction also focuses on the source of legitimacy for the imposition of legal obligation. Finally, “private” law may be used to refer to the law that parties choose through private ordering to support or coordinate their activities, as distinguished from “public” law which is regulatory and imposed on parties’ private orderings.

Calliess’s analysis suggests that in traditional sovereign nation state legal theory all four types of “private” are lined up: the realm of “private law” consists of the law governing relationships between individuals, is coordinative, designed by the parties themselves through contract and derives its legitimacy from contractual consent. Public law, on the other hand, governs the state’s intervention into private relationships, is regulatory, designed by the state, and finds its legitimacy in democratic institutions (parliaments) and procedures (rule of law or due process limits on the state.) As Calliess emphasizes, the distinction was challenged “already under the paradigm of the sovereign nation state” in civil law regimes, largely I believe, as a result of the effort to fit all the different public/private dimensions into a single category. The law of contracts, for example, has important public dimensions in that while the content of obligations may be designed by the parties (how many goods to deliver on what date for what price), the rules governing what is a valid contract, a valid excuse, a proper interpretation of written documents, the appropriate remedy for breach and so on are largely developed by the state and adjudicated and enforced by state actors, notably judges. Private relationships between contracting parties are governed not only by obligations of their own design but also by obligations imposed on them from external sources; obligations of good faith, for

example, fit in this category. And indeed the entire body of tort law, which is quintessentially “private law” in the sense of governing the relationship between individuals and enforced through private litigation, consists of “public” obligations that derive their content and legitimacy from outside the parties to the relationship.

As Calliess notes, in common law systems, the public/private distinction is “seldom noticed.” I think this relative indifference to the distinction arises because in common law regimes, moving from private law (governance of the relationship between individuals) to public law (governance of the relationship between the state and individuals) does not simultaneously bring with it this full set of other transitions from private to public in the nature of law, legal obligation or sources of legitimacy. And indeed, as Calliess also notes, private law (like public law) in the common law regimes is shot through with legal norms imposed on private individuals which are generated neither by contractual consent nor by “democratic consent expressed in parliamentary legislation” but rather by judicial authority. Calliess suggests that the law generated by judges in adjudicating private law disputes is apolitical and coordinative, but I think this is not how common law scholars would see it. The pressure to see it that way is rooted, I believe, in the traditional effort to keep all of the dimensions of ‘private’ law lined up, a pressure that common law scholars “seldom notice.” In a sense, then, Calliess’ important effort to disentangle the sharp public/private divide in the transnational context moves us all onto the muddier terrain where there are multiple public/private dimensions which overlap. On this terrain it is essential to be clear about these different dimensions, to carve some pathways. Some of my disagreements with Calliess’ observations about my own effort to draw sharp distinctions between public and private provision of law and the

different functions of law stem, I believe, from our failure across the literature to distinguish clearly between the different ways in which scholars in different settings use these terms.

## **II. Private provision of law and the distinction between the economic and democratic functions of law**

Let me start then by restating the claims I have made about the potential, and motivation, for private production of commercial law. I begin with a distinction, first articulated in Hadfield (2000), between the economic and the democratic functions of law, more specifically between the efficiency and non-efficiency goals of a political regime. Calliess suggests that this distinction is the same as his distinction between the coordinative and regulatory functions of law, but for reasons I will explore more fully, I believe these are different.

It is important to emphasize at the outset that efficiency is a normative, value-laden, criterion by which we can evaluate relationships and outcomes in a society. It is not a scientific or an apolitical standard. It is a criterion that is adopted only with a view to what a particular society conceives of as the public interest or social welfare.

Economic activity is efficient if it is both productively efficient—resources such as labor, time or capital are allocated to their highest valued uses and outputs are produced with the minimum resources possible—and allocatively efficient—final goods and services are allocated to the users that value them the most. Formally, economists speak of Pareto-efficiency to mean an allocation of resources and final goods in which no person can be made better off by a rearrangement of production or allocation without making someone

else worse off. Pareto efficiency is grounded in a strict utilitarian calculus in which no interpersonal comparisons are made in deciding who should get what; no external third party can say A should get more at the expense of B because A is more needy or B is less worthy. The only redistributions of goods and services allowed are those to which no individual, based on their private evaluation of utility, will object.

Although the articulation of the Pareto criterion is meant to be non-controversial—presuming that all would agree that productive processes should get the most out of resources that we can and there can be no objection, by definition, to the reallocations accomplished in the name of efficiency—it is an overtly normative criterion; it embodies contestable judgments about what is good or bad for society. Economists recognize this: it is a value judgment to say, as the Pareto criterion does, that if B has a lot more than A to begin with, then B should end up with a lot more than A. In many settings we consider it fair, right or just that B, who has much, should give up some so that A, who has little, may be better off. But to manage this normativity, many economists adopt a separation claim, namely that it is possible to separate concerns about efficiency—making the pie as big as possible—from concerns about equity—how the pie is divided up. So, if B has much and A has little, we can reallocate from B to A, and then apply the Pareto criterion—can’t make anyone better off without making someone worse off—to this redistributed reference point.

Some writers in law and economics, notably Kaplow and Shavell (2001), take this a step further, articulating a strong separation claim: the design of legal rules should be focused, exclusively, on generating efficiency and all other normative concerns, about equity for example, should be handled through redistribution via the tax system.

Hadfield (2006) contests this claim, specifically in the context of the potential for a feminist law and economics, arguing that Kaplow and Shavell's strategy to separate efficiency from other normative goals fails because many 'goods' (particularly rights, such as the right to a harassment-free workplace, and non-market goods such own-family care) are not tradeable and thus cannot be purchased with dollars that might be made available through the welfare state. Moreover, building on Sen (1985, 1999), I argue that any coherent use of welfare economics by practitioners of law and economics has to incorporate both the subjective (what we could call 'private' in yet another sense) utility information conventionally used to evaluate efficiency and external (public) judgments about values such as liberty, dignity and fairness. Thus I, like Calliess, take it as a given that efficiency concerns and other normative concerns are sometimes not easily, or at all, separable. But this does not necessarily obviate all efforts at a public/private distinction: distinguishing the economic and democratic functions of law does not imply that all other public/private dimensions must fall out the same way. Identifying the function of a legal rule as "efficiency" does not tell us whether the rule governs private relationships, must be supplied by private actors and enforced through private litigation, or find its legitimacy only in the consent of private parties.

My claim with respect to the potential for privatizing commercial law is not that efficiency is the only criterion of concern or that we can always separate out activities or transactions or organizations in which efficiency is the only concern that we bring to bear in designing a legal regime. So, we are not only interested in efficiency when we think about the organization of the workplace or the choice of more or less polluting production processes by firms. But, I claim, we can identify legal rules or mechanisms the functions



of which are, or can be treated as, exclusively to achieve efficiency: the maximization of gains from trade and the best use and allocation of resources, increasing the size of the pie.

The rules governing contracts between corporate entities, for example—what causes a contractual obligation to come into existence, how contractual obligations are interpreted, how performance is judged and using what evidence, how breach is remedied—have, I believe, only an efficiency dimension. Corporate entities are not political citizens and do not have moral claims to fair treatment or just distribution. That is not to say that their *shareholders* do not have such claims, but the essence of the corporate entity is that the legal status of the corporation is distinct from the legal status of the shareholders. Similarly, intellectual property ownership rights held by a corporation are economic, not political or moral, instruments; their extent, their remedies, their use is measured, I argue, exclusively against the efficiency criterion: how does a particular legal rule governing IP rights affect the efficient production and use of innovative products and processes by corporations? Any moral or political concerns that are rooted in how the state recognizes or rewards individual citizens who produce new works and ideas are a separate matter.

When I speak of the potential for privatizing commercial law, I am focusing on the production, distribution and pricing of the legal rules that are economic inputs into economic activity. Consider, for example, the transborder software contracts studied by Dietz and Nieswandt. Although they do not present the details of these deals, they presumably include clauses that determine how pricing in the contract will respond to changes in variables such as the scope of work for the software. These scope of work

clauses are also likely to be subject to some measure of ambiguity, about what is and is not in the original scope of work and what is and is not the basis for a change in pricing. Widespread principles of contract law see the content of these particular legal obligations—how pricing will relate to scope of work—to be a matter left to the parties, which in my terms is a recognition that efficiency is really the only value at stake. When I speak of the privatization of commercial contract law, however, I am referring not to the content of the legal obligations per se, but rather the rules of the regime governing how these obligations will be interpreted and enforced. So, for example, we can imagine that a dispute over the interpretation of an ambiguous scope of work clause will raise issues about what kind of evidence can be introduced to prove the content: Can evidence of oral agreements about how the clause would be interpreted be included? What relevance will the ways in which the parties have informally resolved the meaning of the clause in the past have? Will the terms of the clause, in the absence of other evidence, be construed against the drafting party or the more powerful party? Can an expert testify to the ordinary meaning of the clause in the industry? The resolution of these questions make up a body of contract rules, and it is this body of rules that I claim potentially can be designed and implemented by a private, profit-maximizing entity. Parties, such as the German clients and foreign software developers studied by Dietz and Nieswandt, can choose to contract under this body of privately-provided rules, much as they now can choose to contract under German law or UNCITRAL rules.

If the private law provider operates in a competitive market environment, the set of rules that are likely to emerge through the interplay of demand and supply can be expected to be efficient. The nature of the evidence allowed, interpretive techniques,

and so on will be offered that generate marginal benefits (in terms of generating value in the underlying software transaction) that equate with their marginal costs. They will not be designed to satisfy jurisprudential experts about what is fair or just or required by due process in the relationship between software client and software vendor. But this is not to say, as Calliess suggests, that fairness or due process will never emerge as a component of what the private market produces. If indeed, as he imagines, German firms in need of customized software and foreign providers of that software will not enter a deal governed by rules that fail to assure a fair resolution of a potential dispute about the meaning of a scope of work or pricing term to which they have agreed, then the private market will produce those rules. But they will not be the rules that necessarily satisfy Aristotelian standards of either corrective or distributive justice; they will just be the rules that satisfy the demand of these corporations for a mechanism that overcomes the obstacles to moving ahead with the deal.

My claim is that, for precisely the same reason that we leave it to a competitive market to determine the particular content of the software development pricing and scope of work provisions, we should also seek to leave it to a competitive market to determine the optimal legal rules governing the interpretation and implementation of those provisions. This is not to say, however, that there is no scope for the state or public law; no role for regulation to accomplish goals other than economic efficiency that may be implicated by the transnational software contract. My proposal that the contract rules governing this private relationship between corporate entities be provided by other private entities does not imply that there are no other relationships affected by the contract (such as the impact the contract might have on German software suppliers or

workers in the software industry or consumers of the products produced using the software), relationships that might appropriately be governed by non-efficiency criteria. It does not imply that the contractual relationship might not also be regulated by “public” entities such as common law judges, state legislatures or transnational political bodies or that the source of legitimacy for such regulation might not be found in democratic (public) rather than contractual (private) forms of consent. Privatizing the *source* of legal rules governing particular dimensions of a relationship does not imply that the entire relationship is allocated to a private legal sphere which, in the traditional sense laid out by Calliess, is strictly coordinative, apolitical and governed exclusively by private entities through private means. I want to discuss three distinct ways in which privatizing some aspects of commercial law will inevitably involve, can allow, and may require elements of public law.

*Combinations of public and private providers of legal services*

First, as Dietz and Nieswand set out nicely in their contribution to this volume and Calliess also discusses, the components of any regime which secures legality in structuring a particular transaction—decisionmaking (adjudication), information processing (legal rules/rule-making) and enforcement—can all be provided by either public or private entities. Enforcement can be provided privately, for example, through the unilateral termination of a valuable contractual relationship by one of the parties in the event of a breach of contract. (This is the self-enforcing contract originally discussed by Telser (1981).) We see widespread use of private decisionmakers, applying publicly provided legal rules and drawing on public enforcement of orders, in international arbitration. Dezalay & Garth (1996). The cotton merchants studied by Bernstein (2001)

combine private legal rules with private adjudicators and a mix of public (enforcement of arbitration orders through a court) and private (reputational, collective refusal-to-deal) mechanisms. Any individual legal rule may thus involve both public and private entities as providers of the legal services of rule-making, adjudication and enforcement.

*Publicly-provided infrastructure for private provision of law*

Second, even if we restrict our attention to legal rules for which all three services of rule-making, adjudication and enforcement are provided by private profit-making entities, like any market, a market for the provision of private law depends on the availability of legal infrastructure. The most obvious sense in which this is true is with respect to contract enforcement: if legal rules or adjudication are privately provided through a market, the transactions (buying and selling legal rules or adjudication services) are likely to require a mechanism for establishing the content of the transactions, judging their performance and remedying their breach. The private provider of legal rules or adjudication makes a commitment, at the time parties choose to draw on the provider's product (such as when they agree to have their substantive transaction—selling cotton, for example—adjudicated under the provider's rules), to provide that service as promised. Often that commitment will be backed by a contract enforceable under publicly provided law.

Even if the legal infrastructure supporting a private legal regime is provided by another private mechanism—such as reputation or private certification by yet another private provider of legality—eventually there is likely to be a point at which publicly provided law plays a role. (Essentially, private displacement of the public legal rules governing an underlying transaction simply moves the locus at which the public law may

need to operate, traveling up the commitment chain, as it were.) All of the mechanisms for supporting transactions are embedded in and generally rely on the publicly provided legal environment, in complex and subtle ways. Hadfield (2005) discusses at length the ways in which simple contract law depends on multiple, generally publicly-provided, legal institutions such as the organization of courts and the legal profession, substantive laws of bankruptcy, procedure, corporations, competition, etc., procedural laws related to evidence production and the conduct of hearings or trials, and the enforcement tools (injunction, garnishment orders, identification of assets, bailiff services, etc.) necessary to collect on a judgment. Here I want to explore the relationship between publicly-provided law and ostensibly non-legal commitment mechanisms such as self-enforcement, reputation, technological and organizational mechanisms. (Hadfield 2005)

Start with the apparently most self-contained commitment devices: self-enforcing mechanisms. The defining feature of these mechanisms, from an economic point of view, is that they can be unilaterally implemented by the party who suffers the default of a transacting partner: a bond or hostage can be retained or a trading relationship suspended. Even these mechanisms, however, depend on the legal environment in which they reside. In particular, they depend on the presence or absence of default or background rules of obligation attached to these unilateral actions. Even a simple suspension of trading is not always and everywhere without legal consequence. The capacity to terminate some relationships is governed by statute. Employment relationships in many countries, for example, cannot be terminated at will; they may require minimal notice or separation payments or they may prohibit termination without good cause. More generally, any relationship is subject to claims of implicit contractual

restrictions on termination, either through the interpretation of explicit terms in the contract or the application of factually or legally implied terms such as the obligation of good faith and fair dealing. Similarly, the capacity to retain a bond or hostage (asset) depends on background laws governing assignment of property rights and potential contract arguments about the nature of the assigned authority over the asset. Moreover, in many settings, a self-enforcing mechanism involving a bond or hostage generates a mirror-image problem, that of the wrongful retention of the bond or hostage by the promisee even after the promise has been performed. Problems such as these are resolved through additional mechanisms such as the use of an escrow agent. The availability of this mechanism, however, depends on the legal environment and specifically the enforceability of claims (common-law or statutory fiduciary duties, for example) on the escrow agent.

Reputational mechanisms, often seen as the epitome of a pure market enforcement mechanism, also depend on the background legal environment. The essence of a reputation mechanism is the communication of information about default to others not involved in the original transaction. The transmission of information is subject to multiple legal rules, including defamation and freedom of expression laws and privacy and confidentiality regulation, whether rooted in statutes or contracts. Laws also affect the extent to which third parties have a right to access information about a potential trading partner, such as credit history, and the extent to which individuals and entities are obliged to disclose information about their past behavior. The willingness and/or authority of courts to maintain the confidentiality of court settlements that might reveal breach of contract or the obligation to disclose defaults to shareholders, for example,

affects reputation. Where reputation is exercised through a community mechanism (Greif 2006), competition laws may come into effect, controlling boycotts and concerted-refusals-to-deal, for example. And where reputation is crystallized into the value of a name or trademark, laws governing the protection of trademarks, and the potential to use trademark law to prevent publication of information relating to the trademark can affect the quality and transmission of information.

Organizational commitment mechanisms—which shift decisionmaking authority to different agents in order to change the nature of the incentives and information that will affect decisionmaking—depend extensively on the legal environment. The capacity to integrate horizontally or vertically is affected by laws governing corporate form and competition. The availability of other organizational structures that might alter incentives—joint ownership of assets, joint ventures, partnerships—depends on a host of legal rules including those determining the legal capacity of an entity to sue and be sued, the liability of owners and managers for third-party harms and their duties to each other, tax regimes, pension obligations, environmental liability and so on. Other organizational structures to support commitment, such as the delegation of control over information or decisions (such as accounting practices or the handling of confidential data) to a third-party, depends on the legal environment in which those third-parties operate: their liability for failure to adhere to professional standards, for example, or to comply with the terms of their delegation.

Even a reliance on technology to support commitment—the use of encryption devices, for example, to back up a promise not to distribute confidential data—depend on legal rules: the intellectual property regime, privacy law, the enforceability of



agreements established through technological means such as click-ware or shrink-wrap. The use of technology to provide legality on the internet, for example, depends on the enforcement of agreements within certification hierarchies and between service providers and users to permit the technological disabling of access when identification or security requirements are not met, and often the protection of trademarks and symbols intended to signal the use of encryption or other security measures. (Hadfield 2005, Gersch & Welling, this volume).

The pervasive role of publicly-provided law in structuring even ostensibly extra-legal enforcement mechanisms takes on particular salience in the global context. Although transborder actors may perceive themselves to be operating beyond the bounds of the state, any actions they take under their contracts must of course happen within a particular country. The background legal regime in that country then shapes the legal status of those actions. Parties that perceive themselves to rely heavily on suspension of a trading relationship as an enforcement mechanism may find themselves facing a legal environment in which one of the parties (especially the party that lives in that jurisdiction) is able to raise the cost or lower the effectiveness of this mechanism by taking the matter to a court inclined to find an implied obligation not to suspend. Networks of traders who travel across borders and rely on information exchange within the network to provide enforcement may find that traders in one jurisdiction are able to draw on privacy laws to stymie the exchange of information or they may find that a weak defamation regime undermines the mechanism by allowing the exchange to become infected with disinformation.

Thus, as a practical matter, the publicly-provided law in individual states inevitably is implicated in the development, use and effectiveness of privately-provided legal/commitment regimes across borders. Thus while much of what evolves through private mechanisms to support global exchange may be the product of private actors, there is a continued role for states individually and collectively to design legal regimes that support cross-border transactions.

*Public regulation of private legal regimes*

Public and private legal regimes are also intertwined as a normative matter. Private legal regimes, as I have mentioned, will successfully provide the legal inputs demanded by transacting parties only if the market for private law is a competitive one. This is likely to require public regulation to some extent. There is the ordinary need for competition law, as in any market for goods or services, to prevent monopolistic practices and anti-competitive collusion. But markets for privately provided legal regimes are likely to be especially vulnerable to market imperfections, due primarily to the extent to which information and ideas are a component of legal products. Let me discuss two of these imperfections.

First, because legal rules are essentially ideas, as goods they are subject to appropriation by those who have not paid for them. Non-excludability is the fundamental market problem addressed by intellectual property laws, which prohibit appropriation under certain circumstances by those who have not paid for the use of an idea embodied in a writing or a performance or a process or a good. Effective development of private markets for legal rules, therefore, requires some form of protection for the ideas embodied in legal rules, to the extent those ideas are the product of investments of time,

resources and effort. This need not take the form of patents or even copyright, although it might. Much intellectual property is protected by private arrangements of confidentiality (contracts binding those who have access to the rules not to use them or reveal them without authorization) and public protection of trade secrets (tort duties of maintaining confidences when information is not publicly shared).

Second, again because legal rules are ideas, and often complex ones at that, they are likely subject to the phenomenon of network externalities. Network externalities exist when the value of a good to any one consumer of the good is increased when there are larger numbers of others who are also consuming the good. The classic example is a telephone system—the more people who connect onto a particular system, the more people any one subscriber can call. The modern example is the computer operating system: the more people there are who use a particular operating system, the more applications and computers using the system there will be for users to buy, and the more expertise there will be available for help in using or fixing the system. This latter benefit from an increased “installed base” helps to explain why legal rules can be subject to network externalities. Particularly if they are complex, the larger the group of contracting parties who use the rules, the greater will be the availability of expertise in using the rules: lawyers and legal personnel within corporations will find it worthwhile to invest time and effort in learning how the rules work and how they are implemented by adjudicators. Like the market for computer operating systems, then, a market for legal rules would face a risk of evolving as a monopoly, potentially leading to abuse of monopoly power and the loss of the benefits that arise from private production. Publicly

provided competition law would then be necessary to ensure that the private market for legal rules operated competitively.

Both of these forms of public regulation are directed to improving the efficiency of private legal regimes. This is why I do not agree with Calliess that the economic/democratic distinction is the same as his coordinative/regulatory distinction. But what of normative goals other than efficiency that are implicated by the transactions structured using a private legal regime? Calliess raises this as a concern with examples such as the impact of corporate governance on labor and distributive concerns with respect to consumer contracts. But the distinction that I aim to draw, and to advocate as an organizing principle for thinking about legal design, is not between *transactions or relationships* that are measured exclusively in efficiency terms and those that are not—I think there are some, but this is not important to my point—but rather between *legal rules or mechanisms* that are measured exclusively in efficiency terms and those that are not. From this point of view, I see no difficulty in the observation, with which I agree, that many transactions and relationships implicate both efficiency and democratic or justice-based criteria. The key is to identify the functions of the multiple particular legal rules or legal regimes that regulate a transaction or relationship. A rule of damages for breach of a corporate contract has as its function the achievement of efficiency: giving contracting firms sufficient confidence in the performance of their contracts to encourage them to relinquish alternative deals and invest in a particular one. The content of such a rule is assessed—from a public policy perspective—on the basis of how well it achieves these efficiency objectives. A rule that allows a firm to rescind its contracts without penalty within three days has as its function an external assessment of the need for third-party

protection of, for example, smaller or less sophisticated firms. Such a rule is evaluated in policy terms in light of how well it achieves the fairness goal of protecting weaker firms from unfair bargaining or exploitation of differences in information or sophistication.

My claim is that the rule governing damages can be privatized and indeed that the legal rule that emerges will be better if its production is privatized.<sup>1</sup> But there is no reason to think that private competition between profit-making firms will generate a legal rule governing contract rescission for weaker firms that achieves fairness goals.

Fundamentally, fairness is external to the values of the parties, and that is all to which private competition can (if it works) respond.

Moreover, subjecting the transaction to the rescission rule is an action taken by third parties external to the transaction—it imposes on them—and is not, like the rule of damages, chosen by them. This takes us to the question of legitimacy, a topic to which I now turn.

### **III. Private provision of law and the problem of legitimacy**

I suggested in the introduction that it was helpful to distinguish at least four public/private dimensions in legal regimes and not to conflate any of those four with the efficiency/democratic distinction I draw on more generally in thinking about legal design. These four dimensions are: the nature of the *relationship* being governed (individual-

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<sup>1</sup> Calliess suggests that I claim that the privatized legal rule will be first-best, in economist's terms. This is only true if the market for legal rules is perfectly competitive, which few real markets are and, as I discuss above, the market for intellectual products such as rules is not likely to be. The relevant question is whether private competition between profit-making firms will lead to a better legal rule than public production by the state. I have looked at this question more formally in the context of corporate legal rules in Hadfield and Talley (2006). We develop a model there in which private competition does not lead to the first-best, but private competition between firms does better than regulatory competition between state legislatures.

individual versus state-individual), the status of the *provider* of legal services (private entities versus state entities), the source of the *content* of legal obligations (the parties themselves or the state) and, relatedly, the source of *legitimacy* (consent or democratic institutions/procedures) for legal obligations. As I discussed in the previous section, legal rules that are directed exclusively to the efficiency function of law can be provided by private or public entities, have their content established by the parties or by the state, and their legitimacy rooted in consent or democratic institutions. My distinction between the economic efficiency and democratic functions of law is thus not intended to line up with a distinction between the public and the private on all these other four dimensions.

Indeed, the distinction between the efficiency and democratic functions of law arises from the critical public/private dimension of legitimacy. My claim has been (Hadfield 2001) that it is for reasons of democratic legitimacy that I have advocated private provision of law only for legal rules which serve, exclusively, efficiency goals. I would like to revisit this question here, particularly in the context of transborder trade and, as Calliess emphasizes, the normative challenges of a transnational civil order.

Legal rules serve exclusively efficiency goals when they can be evaluated in policy terms entirely on the basis of the extent to which they promote the allocation of resources to their highest-valued uses and the production of goods and services with minimal expenditure of resources. In competitive markets, this is what private contracting accomplishes and legal inputs—for example, legal rules governing contractual relationships—promote the value of contracting relationships when they help overcome problems of commitment, private information, costly bargaining, coordination etc. and do so in a way that minimizes the expenditure of resources on legal services of a

given level of quality. The point is not to spend as little as possible on legal services but to spend only up to the point at which the marginal value of the legal service is approximately equal to the marginal cost of the legal service.

In market economies, we leave the assessment of costs and values to private actors engaged in private transactions. If consumers express a willingness to pay for higher quality computers, we leave it to the market to allocate more resources to the production of computers. If the cost of some input such as oil goes up, we leave it to the market to reduce the use of oil, innovate substitute inputs and processes, and shift consumption away from oil-consuming products. A key premise for the conclusion that leaving these valuations exclusively to private actors in exchange will lead to efficient resource use and allocation is that in any given transaction there are no externalities that the transacting parties do not take into account: the quality of a shipment of computers and the oil consumed in their production does not impact anyone other than the buyer and seller of this shipment of these computers. Moreover, we assume that the parties to the transaction are the best judge of their own welfare, and so there is no call to substitute external judgments about value for those reached privately by these parties in this exchange.

The legitimacy of a private legal regime—with law produced by private entities—rests in the consent of the parties who choose to subject themselves to the regime. This is always an appropriate regime from a policy perspective when the only public value at stake is the efficiency of private transactions: the parties themselves are the best judge of the value of alternative transactions and the decision to invoke a private legal regime is best left to them. But, as in the underlying transaction, this is only true if there are no

externalities and no reason to doubt the capacity of the transacting parties to judge the value of legal rules for themselves.

If these externality criteria are not met, as they are not in some dimension for many transactions—the use of oil does, for example, have an impact on others through phenomena such as pollution and global warming—then there is a basis for imposing legal rules—environmental limits for example—on the transaction other than the ones the parties will choose themselves. The question is, can *those* legal rules be imposed by private entities? Clearly they can if the parties consent; and clearly parties do sometimes consent to be bound to rules that are put in place for the benefit of others. But in the absence of consent, the legitimacy of the legal rules must be found elsewhere.

It is this problem of democratic legitimacy that limits my otherwise unreserved proposal for increasing the use of private legal regimes to the commercial setting where efficiency is the only public value at stake. I do not mean to say that private legal regimes, adopted through consent, cannot or will not emerge that will serve other public values such as environmental protection or human rights. There is nothing incompatible with my approach and what Calliess identifies as examples of public/private transnational governance regimes that perform regulatory as well as coordinative functions, imposing limits on corporate governance or consumer contracts. The problem of legitimacy in those cases is resolved through consent.

Furthermore, where the relevant actors are exclusively corporate, and thus the exclusive criterion for evaluating the legal treatment of these entities is efficiency, I see no problem of legitimacy in the imposition of legal rules on these actors without their consent by private legal providers so long as the private legal providers operate in a



competitive market that leads to the production of efficient legal rules. The competitiveness of the market is the protection against outright confiscation of corporate wealth by private legal entities—if the private regulatory rules are efficient they generate pollution limits, for example, only to the extent that such limits promote efficient use of polluting resources such as oil. There may well be *practical* problems—whether competitive markets for regulation that are not based in the consent of the regulated can exist is a question I have not explored in depth. But I do not believe there is a problem of *legitimacy* in this corporate context: as I indicated earlier, I believe corporate entities exist for the purpose of efficient markets and (unlike their shareholders) do not have political or moral claims. The limit on regulatory imposition is determined by what is efficient, not by what is fair or just in the treatment of the corporate entity.

But where the limits on regulation are rooted in values other than efficiency, where legal rules are imposed without consent on people who do have democratic claims on fair and just treatment, the privatization of law cannot easily be legitimated. I do not know if it can never be—this is a question I have not explored, although Hadfield (2002) discusses the use of ICANN—a private non-profit entity—to regulate both corporate and natural persons’ access to the domain name registration system on the Internet. But it is clear that there will be many cases in which it cannot be. The democratic nation state draws on a variety of mechanisms to legitimate the imposition of law on individuals without their consent: legislative and administrative bodies subject to the requirements of political accountability to an electorate, constitutionally constrained courts, and so on. The challenge is to understand how transnational law-imposing entities can operate

democratically in order to legitimate the imposition of legal rules on individuals with democratic claims.

## **IV. Conclusion**

Studying the potential for private provision of transnational legal regimes involves several components: empirical/descriptive, theoretical/predictive and normative/prescriptive work. Empirical work on the kinds of legal regimes we see emerging in the transnational setting—such as the work of Gersch and Welling and Dietz and Nieswandt—provides us with important input in understanding what might be theoretically possible for private provision of law as well as what might be normatively desirable. The fact that Dietz and Nieswandt, for example, find little evidence of reliance on private legal regimes in the computer software contracts they studied, for example, indicates that we need to explore whether such regimes have not emerged because they do not meet the needs of the parties or whether they lack the public law infrastructure necessary to come into existence.

Calliess's contribution is not empirical per se, but he does appeal to the patterns of public and private law production in the transnational setting in challenging the value of the efficiency/democratic distinction I advocate and I think it is important to be clear here about the relationship I see between the empirical evidence and the normative project of evaluating the desirability of privatizing law production. I think Calliess is right to point to the emergence of mixed public-private transnational governance regimes which cross over from coordinative to regulatory functions as evidence of the possibility that democratic legitimacy may be rooted in the transnational setting outside of the conventional national legislative setting. Common law scholars are probably less

sensitive to this observation than civil law scholars because of the longstanding need to theorize the democratic legitimacy of common law judging within the nation state. But the fact that mixed public-private transnational governance regimes are, in fact, supplying law that is not only coordinative but also regulatory in nature does not, of itself, solve the problem of democratic legitimacy. I suspect many of the cases Calliess has in mind involve consent to the imposition of the relevant legal rules. But in any event, it is clearly a project called for in the study of the emergence of transnational civil society. Particularly because, as Calliess notes, so much of what takes place in the transnational setting is driven by commercial corporate actors who can adjust their transactions to shift outside of the reach of national legal regimes, it is important, I believe, to be sharply attuned to the distinction between the economic efficiency and the democratic functions of law. The private market processes that will emerge rapidly in the transnational setting may well serve the efficiency function, but I suspect achieving the democratic functions will require political, not economic, global action.

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