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Producing Law for Innovation

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2: Producing Law for Innovation[1]

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It is a lesson we know well from the events of the past several decades: Whatever their flaws, regulated markets do a better job than central planners in governing the production and distribution of goods and services. They do so because they harness private incentives to seek out the potential for creating value and because they are capable of processing massive quantities of data and responding to complexity. They don't accomplish these goals without legal structure and constraints—to provide the basic framework for transactions and cooperation (property and contract, for example) and to control externalities and exploitation of the disparities created by the unequal distribution of information and resources. But the problem of creating the legal framework to support and regulate markets to produce goods

[1] This chapter is largely based on Gillian K. Hadfield, "Legal Barriers to Innovation: The Growing Economic Cost of Professional Control Over Corporate Legal Markets," *Stanford Law Review* 60 (2008): 1689-1732; Hadfield, "The Role of International Law Firms in Harmonizing Legal Regimes," in *Multijuralism: Manifestations, Causes and Consequences*, ed. Albert Breton et al. (Surrey: Ashgate, 2010); and Hadfield, "Law for a Flat World: Legal Infrastructure and the New Economy," 2010, available at works.bepress.com/ghadfield.

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and services, while daunting, is still an easier one to solve than the massive one of how to direct individual flows of economic inputs and outputs.

Regardless of how well we have learned this lesson when it comes to goods and services, however, we have yet to recognize that it applies as much to the complex task of producing the legal inputs that structure and regulate markets as it does to the task of producing more familiar economic goods and services. Deciding how to regulate a financial institution to forestall massive coordinated failure is as complex a task as determining how to portion and price the risky assets the institution buys and sells, what algorithms will most efficiently conduct trades, and what organizational structures will create the best incentives. Yet by and large we allocate all the latter tasks to the market—private, generally profit-driven firms and entrepreneurs—and the former task to central planning by public actors: politicians, regulators, and judges. Even the ostensibly private players in the legal field—lawyers—operate within a highly insulated market that leaves it up to judges (but, practically speaking, lawyers themselves) to determine who may provide legal services, where, and through what type of organization.

The neat distinction we take for granted—private actors decide how much to produce and how to price it through decentralized market decision making, while public actors set the rules for markets through deliberative and political decision making—may have served us well in a far less complex economy. And indeed, until the late nineteenth century, the legal needs of a (still heavily agrarian) market economy were largely taken care of by the rules of property and contract generated by common law judges and courts. The rise of mass-market manufacturing, transportation and communications in the late nineteenth century fostered the growth of large-scale federal regulation: The first federal regulatory agency, the Interstate Commerce Commission, was established in 1887 and one of the first major federal regulatory statutes, the Sherman Act, was passed in 1890. But even as the economy grew more complex, the goal for regulation remained

relatively simple: control the capacity of large-scale enterprises to increase prices and reduce wages.

The regulatory goals of the twenty-first century are far more complex. We do not want merely to constrain monopoly power; we also want to foster economic growth and innovation to achieve a diverse set of public and private goals. Moreover, the environment in which our regulatory efforts must operate is characterized by high levels of complexity and rapid change. This puts great pressure on the capacity of deliberative central planning to generate the structural and regulatory rules necessary to coax the results we want out of decentralized agents. The information demands alone are staggering and beyond the ken of isolated institutions or comprehensive rational analysis. Again, we know this in the context of ordinary economic production. We call this the "knowledge economy" because information is an increasingly essential input into the production process and a key economic output. In order to compete, producers of goods and services have to be deeply in touch with and capable of responding to exploding amounts of information. To do so, they are moving away from the model of hierarchical organization—the prototypical twentieth-century "managerial enterprise" engaged in the rational top-down planning that Alfred Chandler (1977) described[2]—and toward highly decentralized models that rely on networks, open innovation and flexible alliances in order to harness the capacity to process and respond rapidly to new information.[3] Moreover, they are doing so on a web-based platform that is fundamentally global and not national in structure. And yet we still are looking to centralized bodies such as national and state legislatures, regulatory agencies, and courts to write the rules of the system.

As we explore the nature of the legal rules necessary to achieve the dynamic goals of growth and innovation, we need also to consider the fundamental question of the production methods by

[2] Alfred D. Chandler, Jr., *The Visible Hand: The Managerial Revolution in American Business* (Cambridge, MA: Belknap Press, 1977).

which these rules will be generated. Much of our discussion about the rules for growth assumes that the rules can be developed by deliberation and rational analysis—by law professors, economists, judges, regulators, legislators (and their lobbyists)—and implemented by rational processes: voting, agency rule making, judicial argument, and decision. We undoubtedly have to continue to rely heavily on these methods to produce legal rules and procedures to foster growth and innovation. But it is essential—in order to cope with the staggering information and adaptation demands of a high-velocity, innovation-intensive global economy—also to harness for the benefit of legal production the same decentralized and market-based methods we rely on for the innovation and production of ordinary goods and services.

We should be looking for ways to foster the development, for example, of competitive private providers of legal rules and procedures, providers who succeed or fail based on the success of their systems in achieving the goals established for them. Instead of or in addition to the jurisdictional competition between the legislatures of Delaware, Nevada, and Pennsylvania for the business of incorporation and corporate governance systems that Butler and Ribstein discuss in this volume,[4] we also should be looking for competition between "Governance Inc.," "Corporation.com," and "Enterprise Partners." Similarly, instead of competition between California and New York for the business of providing contract law, we should be looking for competition between

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[3] Todd R. Zenger and William S. Hesterly, "The Disaggregation of Corporations: Selective Intervention, High-Powered Incentives, and Molecular Units," *Organization Science* 8 (1997): 209–22; Bengt Holmstrom and John Roberts, "The Boundaries of the Firm Revisited," *Journal of Economic Perspectives* 12 (1998): 73-94; Timothy J. Sturgeon, "Modular Production Networks: A New American Model of Industrial Organization," *Industrial and Corporate Change* 11 (2002): 451–96; Richard N. Langlois, "The Vanishing Hand: The Changing Dynamics of Industrial Capitalism," *Industrial and Corporate Change* 12 (2003): 351–85; Naomi R. Lamoreaux, Daniel M.G. Raff, and Peter Temin, "Beyond Markets and Hierarchies: Toward a New Synthesis of American Business History" *American Historical Review* 108 (2003): 404–33; and Ronald J. Gilson, Charles F. Sabel and Robert E. Scott, "Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration," *Columbia Law Review* 109 (2009): 431.

[4] Henry Butler and Larry Ribstein, "Legal Process and the Discovery of Better Policies for Fostering Innovation and Growth," this volume, chapter 19.

"Contract Management Ltd." and "Simple Contracting Unlimited." Instead of competition between the United Kingdom's Financial Services Authority and the Securities and Exchange Commission, we should be looking for competition among multiple private, for-profit and nonprofit entities for the business of supplying approved regulatory regimes. And instead of a single monopolized "legal" profession controlled by bar associations, we should be looking for a wide variety of alternative suppliers of legal advice, documents, relationship management, liability predictions, and representation. In this more open and competitive world of legal production, we could turn not only to the expert judgment of traditional legal practitioners operating in law firm partnerships to decide what language to include in a contract or what pretrial motions to bring, but also to data analysis companies that use sophisticated software to analyze liability risks and rewards. We also could turn to not only contracts and threatened litigation to manage business deals, but also to relationship management companies that integrate legal and nonlegal tools to help commercial parties allocate risk, coordinate the efforts, distribute rewards, and resolve disputes. Similarly, we could turn not only to traditional bylaws and board meetings to govern the corporation, but also to digital platforms that coordinate and implement corporate activity.

In this chapter, I first discuss why we need to think of legal infrastructure as economic infrastructure requiring focused economic policymaking, what is wrong with our existing legal infrastructure, and why we need to change our modes of legal production. I then set out a vision of what greater reliance on market-based production of legal infrastructure could look like. Finally, I suggest some concrete steps that policymakers can take to move us toward a more open, competitive system of legal production. These include:

- **Opening up access to the provision of legal services**, initially by creating a federal licensing regime that exempts providers from state-based regulation by the bar and state supreme courts. Among other things, the federal regime should

eliminate restrictions on the ownership and management of the providers of legal goods and services to commercial clients and geographical restrictions on where these entities supply their products.

- **Establishing the public law framework necessary to enable competitive private legal providers to emerge**. An easy place to start with this is authorizing private (not necessarily lawyer-owned and managed) firms to supply commercial contracting and recognized incorporation/corporate governance regimes.
- **Reducing barriers to trade in legal services**. In addition to reducing the state-by-state barriers now imposed on the provision of legal services domestically, policymakers also should move to eliminate international restrictions on legal services transactions that cross international borders—protecting overseas legal process outsourcers and law firms, for example, from the threat of unauthorized practice of law charges and obtaining reciprocal trade benefits for U.S. legal providers in foreign markets.

Legal Infrastructure is Economic Infrastructure

If the first lesson of the collapse of centrally planned economies during the past several decades was that regulated markets are better at directing resources to produce and distribute value, the second lesson was that markets require a great deal of legal infrastructure in order to function effectively. Comparing Russia and Poland after the fall of the Soviet state, Jeffrey Sachs (a principal economic advisor to both countries in the early 1990s) concluded that "the contrast in reform outcomes . . . revolve centrally around the differing roles of law in the two societies" and that "it is in the legal realm that we find many of the deepest weaknesses and greatest hopes for our age."[5]

[5] Jeffrey Sachs, "Globalization and the Rule of Law," *Yale Law School Occasional Papers*, paper 2 (2008), http://digitalcommons.law.yale.edu/ylsop_papers/2.

I define *legal infrastructure* as the set of legal inputs available to the participants in an economy to structure and regulate their economic relationships. This set includes formal legal rules and principles, but it goes well beyond the laws on the books. It also includes:

- the formal and informal elements of procedure for invoking or challenging the enforcement of rules—such as civil procedure and evidence codes;
- the norms and practices, and costs, of legal advising;
- the standard forms and collected contract and other document templates available in legal databases, and the procedures and rules that govern access to those databases;
- the accumulated conventional wisdom about regulatory and dispute-resolution strategies; and
- the stock of knowledge accumulated by legal practitioners through formal education, trade publications, conferences, patterns of training and expertise, and anecdotal experiences.

These features of the legal environment influence the cost and efficacy of any particular legal solution that might appear on the books, and they affect the likelihood of learning about and deploying such a solution. They are inputs to an economic output, namely the structuring of a particular economic relationship.

Why call this legal "infrastructure" and not legal "system" or "regime"? The concepts of legal "system" or "regime" generally refer to the formal elements of a legal environment—and in particular, its formal institutional structures such as the role of the judiciary or constitutional allocation of powers—and focus on the law as seen from the vantage point of the lawyer and judge. These concepts frame deliberative legal analysis, the formal design of legal processes and argument. The concept of infrastructure, in contrast, emphasizes that, like the classical forms of physical infrastructure—highways, railways, electric power grids, telephone lines—and the critical infrastructure of the information economy—the Internet—legal infrastructure "lies beneath" the

economic relationships it helps to structure. It is "embedded in other structures, social arrangements and technologies," and while designed, it is ultimately organic and emergent: "Infrastructure does not grow *de novo*; it wrestles with the inertia of the installed base."[6] Perhaps most importantly, the concept of infrastructure shifts the focus away from the perspective of legal analysts and onto the perspective of those who use law to structure their relationships. It emphasizes the pervasive role of law in everyday efforts to coordinate and support cooperative economic activity. If we want to speak to someone in a distant place, our ability to do so is structured by the quality and reach of the voice communications infrastructure. If we want to risk investing time, opportunity, and wealth into a joint venture with someone, our ability to do so is structured by the quality and reach of our legal infrastructure. And like physical infrastructure, what we care about is what we can do and at what cost with the tools actually available to us in this infrastructure, not the blueprint for the system as designed by its engineers. A telephone system is no good to us if it requires an overly expensive handset or if the system has been hacked to broadcast our conversations. Similarly, a legal system is no good to us if it requires overly expensive lawyers, or if in practice the application of legal rules is distorted by graft or incompetence.

Legal infrastructure as I've defined it is economic infrastructure. This is not true of all law, of course. Law also provides the fundamental architecture of democratic political relationships: the rights and duties of citizens and the authority and limits of democratic institutions. But the elements of law on which I want to focus are those that structure and regulate economic relationships—these account for a very large share of law in modern market democracies. It is in this context that I emphasize that legal inputs such as rules of contract or the practices of corporate attorneys are fundamentally economic inputs. It is also in this context that we need to approach the question of legal policy—what

[6] Susan Leigh Star and Karen Ruhleder, "Steps Toward an Ecology of Infrastructure: Design and Access for Large Information Spaces," *Information Systems Research* 7 (1996): 111–134.

should our legal rules and institutions look like and how should they be produced?—as a question of economic policy. This is why I take as my starting point in analyzing the production of law the same starting point that we adopt when analyzing how other economic goods and services should be produced: Should this be produced by the state or by the market? If by the market, what is the proper role of government in supporting and regulating this market? In the normative framework we adopt in this book, these are questions that I analyze with reference to dynamic efficiency, innovation, and growth. This is not to deny an important role for political constraints based on the goals of equality, fairness, autonomy, security, dignity, and so on. These are legal objectives that are legitimately produced within accountable political institutions and not private markets. But it is important to see clearly that much of our legal policy is not fundamentally political or jurisprudential; it is economic. There is therefore a much broader scope for market-based legal production than currently recognized.

What does our existing legal infrastructure look like?

Most people take it as definitional that law is a political, bureaucratic, and judicial product generated by legislatures, administrative agencies, and courts. And indeed, the more formal elements of our current legal infrastructure—legal rules and principles—are largely produced by federal and state governments and judiciaries. There are pockets of nongovernmental rule production. In the financial industry, for example, individual exchanges and the Financial Industry Regulatory Authority (FINRA) generate rules for their members under the oversight of the SEC. Many trade associations, including those for grain, cotton, and diamond merchants, provide systems of contracting and dispute resolution to govern their members.[7] Many think of contracting itself in the Anglo-American tradition—in which contracting parties rather than the state design the rules governing their relationships—as an example of private lawmaking. But these are relatively limited

exceptions to the dominant reliance on legislatures, government agencies, and courts to formally generate binding legal rules. This means that nearly all of our legal rules are produced through political and deliberative mechanisms: committees, lobbying, voting, litigation, and formal abstract reasoning. Rules emerge, or do not emerge, based on whether they appeal to voters, experts, and judges—not necessarily on the basis of how well or efficiently they accomplish a task or whether they can survive competition with an alternative that achieves the goals of legal regulation better or more cheaply, or with greater product differentiation. To the extent there is competition, it is regulatory or jurisdictional competition between legislatures and public regulators. While such competition can promote better legal rules,[8] it is important to recognize that it does not follow the same logic or necessarily produce the same results as competition between private profit-maximizing firms.[9]

Legal services are provided in markets—almost all lawyers are private individuals who charge for their services (1 percent are public defenders and legal aid attorneys who may be employed by governments or funded by nonprofit agencies)—but our markets for legal services are among the most closed and highly regulated markets in the U.S. economy. Entry into the legal services markets is heavily restricted: Bar associations and state supreme courts claim regulatory authority over the entire "practice of law," which is vaguely defined but generally amounts to "anything lawyers do."[10] Providers must obtain a law degree, the requirements of which are set by state bar associations, which

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[7] Lisa Bernstein, "Opting Out of the Legal System: Extralegal Contractual Relationships in the Diamond Industry," *Journal of Legal Studies* 21 (1992): 115; Bernstein, "Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms," *University of Pennsylvania Law Review* 144 (1996): 1765; and Bernstein, "Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms and Institutions," *Michigan Law Review* 99 (2001): 1724.

[8] Erin O'Hara and Larry Ribstein, *The Law Market* (New York: Oxford University Press USA, 2009).

[9] Gillian K. Hadfield and Eric Talley, "On Public versus Private Provision of Corporate Law," *Journal of Law, Economics and Organization* 22 (2006): 414–441.

[10] Hadfield, "Legal Barriers to Innovation."

serve as the exclusive accreditation body. Accreditation standards for law schools are significantly more intrusive than other professions such as engineering. Moreover, because a license to practice is dependent on passing an exam set by the bar association, law school curricula are heavily oriented toward achieving educational objectives controlled by lawyers themselves. Collectively, these entry requirements generate a homogenous pool from which the entire industry is supplied—there is little room for entrepreneurial entrants who might devise unconventional methods of achieving the goals of law more quickly, cheaply, and effectively. If a similar regulatory structure had been in place in the 1990s in the "practice of information cataloging and search," we wouldn't have Google. Its founders, Sergey Brin and Larry Page, who were PhD students in engineering at the time, would have been required to obtain advanced degrees in library science before being authorized to develop new methods of organizing and finding information.

Once admitted into the industry, any legal entrepreneurs who have survived the homogenizing forces of law school and the bar exam face further barriers. In the ostensible name of ethics, bar associations (endorsed by state supreme courts) place severe restrictions on the organizational and financial structure of legal businesses. Legal services can only be provided to the market by lawyers who operate within firms owned, managed, and 100 percent financed by lawyers. (Lawyers who are employed by other types of organizations can only provide in-house legal services to their employer.) This means that legal inputs cannot be provided by corporations that are financed with public or private equity or that are created or managed by nonlawyers. Nor can entrepreneurs seek the backing of friends and family, angel investors, or venture capital firms to support the development of new legal business tools, markets, and models. This severely restricts the potential for innovation. Entrepreneurs outside of law who see a better way to do things are prevented even from engaging in a joint venture with lawyers to deliver services. Even law firms owned by lawyers cannot put in place the kind of covenants not

to compete that other businesses routinely implement to protect the business against losing customers to departing employees who rely on firm contacts to build their business. This limits the potential for a law firm to build firm capital and diminishes the incentive for the firm to invest in innovation, training, and growth.

Our heavy reliance on government production and a professional monopoly administered by lawyers generates a legal infrastructure characterized by several features that hamper our ability to support innovation and growth. These features include:

Heavy reliance on document/text-based rules: Our legal environment is awash in a high volume of document-based rules. There are more relevant documents, and the length and density of documents such as statutes, legal opinions, and contracts are, by all accounts, much greater today than fifty years ago. (Compare the length of the Glass-Steagall Act of 1933—thirty-six pages—to the length of the 2010 Financial Services Reform Act—almost 2,000 pages.) The problem is not merely volume. Growing specialization within legal practice[11] makes skilled interpretation of many legal documents the province of a shrinking subset of legal experts.

Human capital–intensive craft production: Legal services are characteristically provided on a scholarly craft model: The legal situation facing an individual client is evaluated by an attorney on an individual basis and an individualized strategy or plan is developed and implemented. Lawyers rely heavily on acquired experience and personal judgment in assessing the likely content and consequences of a legal relationship. There is little systematic and quantitative data either available or put to use in developing legal advice or documents. There is minimal use of automated or computer-based methods to produce or deliver legal inputs, such as the predicted effect of different contract clauses or compliance strategies.

[11] John P. Heinz, Robert L. Nelson, Edward O. Laumann, and Ethan Michelson, "The Changing Character of Lawyers' Work: Chicago in 1975 and 1995," *Law and Society Review* 32 (1998): 751.

Undiversified production models: With the important exception of in-house counsel (approximately 8–10 percent of the profession), almost all lawyers work in all-lawyer environments where they are exposed to the ideas and problem-solving techniques of people with their same training and intellectual orientation.[12] There are few collaborative enterprises that merge legal expertise with other business expertise. Legal enterprises must be exclusively financed by withheld profits and bank loans, cutting innovators off from large-scale capital markets, private equity, and third-party financing and insurance. This lack of financial diversification limits the risk-bearing capacity of the firm and may account in part for the high levels of risk aversion we see in legal practitioners more generally.

Mandatory rules: Most of the legal rules governing the conduct of a company or organization and available to it for structuring its business dealings are the product of government actors and are by and large mandatory: Their applicability is not a matter of choice for the affected entities. There are important exceptions—such as the choice of state of incorporation or governing contract law—but there is little scope for choosing a regulatory or liability regime. Moreover, with the potential for claims to be framed as legal questions in multiple ways, the set of mandatory rules applicable to a given activity is frequently fragmented and overlapping.[13]

What's wrong with our existing legal infrastructure?

Of course, there is no reason to explore the potential for law to be supplied by competitive private markets if the largely nonmarket

[12] Heinz et al.

[13] Robert Kagan, *Adversarial Legalism: The American Way of Law* (Cambridge, MA: Harvard University Press, 2001), 25–29, presents a detailed picture of how multiple federal, state and municipal regulatory agencies, along with federal and state courts, generated a tangled web of litigation and regulatory process that delayed by several years the dredging of the harbor in Oakland, California to accommodate larger containerships.

legal infrastructure we currently have is serving our policy objectives of dynamic efficiency, innovation, and growth. But there are solid theoretical reasons to think it is not, particularly as the new web-based global economy moves into full swing and innovation and dynamic adaptation become key drivers of growth. The transformations in the economy that we have witnessed in the past two decades, with globalization and the migration of much of the organization of work, trade, and communication onto the Internet, also has transformed the nature of what we need law to do in order to support and regulate economic activity.

Compared to the prototypical firm in the early to mid-twentieth century, when our current legal infrastructure was laid down, the prototypical twenty-first century firm demands more and different legal inputs to meet several shifts in the economic demand for law. These shifts include:

Increased firm-boundary crossing: The pervasive shift away from vertical integration to increased reliance on networks, alliances, and global supply chains generates heavy demand for contracting inputs that are capable of managing more complex, flexible, and information-rich relationships. Today the paradigmatic contractual relationship is a joint venture or outsourcing contract, posing very different contracting challenges than the paradigmatic sales contract of the nineteenth and early twentieth century.

Increased jurisdictional boundary crossing: A greater demand for complex contracting inputs is also prompted by the significant increase in cross-border transactions. Regulatory approaches also have to cross jurisdictional boundaries more frequently and in more complex ways as the extent of global interconnection increases.

More pervasive and complex transactions in information: In the new economy, information is a prime object of economic transactions, and information asymmetries are a pervasive attribute of bargaining relationships. But transactions in information or under information asymmetries are especially difficult to structure. There is therefore a greater demand for various forms of protec-

tion for intellectual property—particularly IP that is not embodied in a concrete product—and for more tools to address the contracting obstacles information assets pose.

Faster depreciation and obsolescence of legal solutions: The higher velocity of the new economy reduces the lifespan of any particular legal solution, and shifts the relative value of adaptable as opposed to fixed solutions. This requires greater emphasis on dynamic as opposed to static legal analysis.

Increased differentiation of demand: The new economy is characterized by more heterogeneity in products and business relationships. This implies a more differentiated demand for legal solutions. As firms innovate new products and relationships, they face challenges often highly specific to their circumstances. Unlike the sales relationships that dominated the "old" economy, one size does not fit all, or even very many, very well.

Lower margins for legal transaction costs: Legal solutions that have a shorter lifespan and that are developed to address particular rather than standardized products, contexts, or relationships have to be cheaper. The global scale of competition can also put more pressure on transaction costs than was the case in the era of relatively insulated megafirms. And the startups and entrepreneurs who are the lifeblood of the innovation economy lack the scale and financial wherewithal to take on substantial legal expenses.

Greater demand for integration of legal and business expertise: In an economy with high levels of standardization, we can expect legal solutions to effectively capitalize knowledge about the business or regulatory considerations that, for example, a sales contract or employment policy needs to address. But in an environment of heterogeneity and rapid change, the essential problem solving that is at the core of legal work is an ongoing task. This requires legal analysis that is explicitly integrated with all of the elements of business problem solving, rather than unexamined reliance on the solutions found in standardized processes, strategies, and documents.

The changes in what we need in order to address the legal needs of the new economy are now substantially mismatched with what our old-economy legal infrastructure has to offer. The scholarly craft orientation of law implies that lawyers, regulators, judges, and legislators respond to the complexities of the globalizing new economy with the idea that more complexity in the environment must be met with more, and more complex, documents: more words and more specialized drafting. But this is a very costly and slow process and runs counter to factors that are increasing the demand for less costly legal solutions to deal with an increasing number of heterogeneous relationships that are bound to change in short order. Longer, more complex documents and statutes increase the specialization in human capital required to implement and engage in adversarial (often winner-take-all) contests organized around these written materials. But human capital specialization is a key reason why legal markets are noncompetitive—raising the price of legal solutions in a profound way that goes beyond the simple notion that it takes more work to draft 100 pages than it does ten.[14] Greater legal specialization also increases rather than decreases the challenges of integrating legal and business problem solving. This increases the gap between what legal solutions provide and what enterprises and regulators need to address novel, challenging, and rapidly changing environments.

In a competitive environment, we would expect legal providers to adapt to and fix these problems. But the structural features of our legal infrastructure largely prevent competitive responses such as these. Many of the rules are publicly provided and politicians and regulators do not face competitive incentives organized around the efficiency of the statutes and regulations they produce. Because most legal rules are mandatory, there is little scope for businesses or those with regulatory goals to shift to a more productive legal environment. And because of the tight regulation lawyers have imposed on their own profession, there is little

[14] Gillian K. Hadfield, "The Price of Law: How the Market for Lawyers Distorts the Justice System," *Michigan Law Review* 98 (2000): 953–1006.

scope or incentive for innovation in even the ostensibly market-based aspects of our legal infrastructure. These are the features of our legal system that are most in need of change in order to promote innovation in the legal infrastructure that will better serve the needs of dynamic efficiency, innovation, and growth.

What would market-based legal production look like and why could it do better?

Market-based production of legal inputs already can be found to some degree in our existing legal system. Private nonprofit organizations such as the American Institute of Architects create and distribute (and sometimes copyright) standard contracting forms for the use of their members and the general public. Commercial entities such as Nolo Press and LegalZoom sell blank documents or software to help people create documents. Most organizations, largely on a contract basis, develop and implement their own internal grievance and human resources procedures. Private dispute resolution services are widely available either as arbitration or mediation. There are market-based document preparers who can fill in documents such as bankruptcy petitions, and e-discovery providers who store and sift through high volumes of electronic documents for litigation purposes.

But these represent ultimately small and still fairly restricted slices of the legal pie. In a world with fewer restrictions on market-based provision of legal inputs, the array of market options would be far greater than it is now. Although one of the key attributes of markets is that they can produce surprising solutions that abstract analysis cannot, we can make some conjectures about what this world would look like.

We would expect a more open legal market to include a variety of providers of legal services, not just JD-trained bar-examined lawyers. Indeed, England and Wales already have eight alternative training and licensing regimes for different types of legal providers, many of whom compete to serve the same clients with legal advice, planning, and representation. Some of these regimes

require the traditional university degrees; others are based on community college programs or practical training and experience-based qualification. In this kind of environment, different demand characteristics operating through this market can sort out who works for whom doing what kind of work, increasing the differentiation and variety required by a more heterogeneous economy.

We would expect a more open market also to be characterized by corporate legal providers, not just lawyer partnerships, and by entities that integrate legal services with a broader array of goods and services. Large retailers such as Office Depot, which now provide banking, copying, or postal services, could add to their repertoire legal services such as regulatory information and document filing for small businesses. These services then could be provided by employed professionals who have available to them practices and procedures developed on the basis of market testing and data and backed by the quality incentives and malpractice liability of a large organization, rather than the resources and experience of relatively isolated solo practitioners or small local partnerships. The megafirms now providing e-discovery services on a national (if not global) scale, but limited to document storage and filtering, could integrate these services with legal expertise, likely informed not only by traditional legal judgment based on human capital, but also on large-scale data analysis. Legal process outsourcers such as CPA Global would not be required, as they now are in most states, only to provide services under the supervision of a licensed attorney who retains them, assumes liability for them, and serves as a middleman. In a less restrictive environment they could compete head-to-head for clients on a bundled or unbundled basis. This is especially important for startups, as well as small and medium-sized businesses that lack large legal departments. Faced with regulatory, contract, or litigation concerns, these smaller entities could turn to lower-cost and differentiated sources of information and advice (summaries of the law, legal research, document selection, and advice in preparation comparable to accounting advice on taxes, for example), and

likely obtain delivery in formats that are better attuned to their needs and budget.

More radically, greater market-based provision of law would also include a greater role for private for-profit and nonprofit entities in providing legal rules.[15] While there is an extensive role for private contracting, private contracts still are subject to state-provided rules of validity, interpretation, and enforcement. But a market-based provider of such rules with an incentive to gain market share and access to investment capital to devote to the costly process of designing better solutions could conceivably shift the entire function of designing and managing contractual relationships away from adversarial dickering over contract language and toward creative multipronged methods for allocating risks, coordinating activities, adapting to change, and resolving disputes. A private competitive corporate governance regime—supplying the rules that are now supplied by state legislatures—could conceivably offer dramatically different models for creating and managing the corporation. In this volume, for example, Oliver Goodenough describes a privately provided digital corporate governance platform that incorporates and then coordinates the relations among owners, managers, and agents. Many of these functions could be performed via algorithms, including algorithms that organically adapt to changing conditions and environmental feedback. Developing systems like this requires entrepreneurial energy, creativity, and investment capital—things lacking from our current deliberative and public systems of law production.

Shifting the provision of the rules governing contractual and corporate governance relationships to more market-based providers is a relatively easy step. Farther on the horizon we can imagine, however, a greater role for privately provided regimes to substitute for or complement existing publicly provided securities,

[15] Gillian K. Hadfield, "Privatizing Commercial Law" Regulation 40 (2001); and Hadfield, "Delivering Legality on the Internet: Developing Principles for the Private Provision of Commercial Law," *American Law and Economics Review* 6 (2004): 154.

environmental, product safety, intellectual property, and other regulation. Organizations in this world would choose their regulator from a competitive array of providers, including private providers. Legal scholars already are discussing the potential for a "portable" securities regulation scheme under which issuers select their regulatory regime from those offered by participating countries, regardless of where they physically issue securities.[16] Expanding the set of available regulators to include private providers requires rethinking the role for public actors in this process, shifting that role from the detailed enactment of thousands of pages of statutory and regulatory provisions to the certification and oversight of competitive private regulatory bodies.

In the United States, securities regulation has included government oversight of self-regulatory bodies such as stock exchanges and broker-dealer associations since the passage of the Securities Exchange Act of 1934. Other professions, including the legal profession, are also private sources of self regulation. There are two key, related, differences between our existing self-regulatory model and the model of competitive private regulatory bodies that I am envisioning. First, self regulation generally refers to a membership organization's regulation of its members. FINRA, for example, regulates those who are members of the New York Stock Exchange. This ties the provision (and hence incentives) of the regulatory product to the provision of the underlying product—in the case of the NYSE, access to a dominant exchange. Second, and related, the providers of regulation are generally monopolists within a broadly defined field. The NYSE might compete with other exchanges for business, but there are no competing regulatory providers for those who want to be members of the NYSE. These features of self regulation weaken the market incentives directed toward better regulation, and raise an almost insurmountable barrier to deauthorizing a private regulator gone

[16] Stephen J. Choi and Andrew T. Guzman, "Portable Reciprocity: Rethinking the International Reach of Securities Regulation," *Southern California Law Review* 71 (1998): 903; Roberta Romano, "The Need for Competition in International Securities Regulation," *Theoretical Inquiries in Law* 2 (2001): 387; and Howell E. Jackson and Eric J. Pan, "Regulatory Competition in International Securities Markets: Evidence from Europe in 1999: Part I," *Business Law Review* 56 (2001): 653.

astray: Deregistering the NYSE as an authorized exchange because of regulatory failures is probably not on anyone's reform agenda. In a more open system of privately supplied regulatory systems, the provision of regulatory services could be provided separately from membership in an underlying economic entity. We could expect to see the emergence of regulatory service firms, specializing in the design and implementation of regulation to achieve publicly established performance goals. These firms would compete, and would be exposed to the risk of product innovation and cost reduction from other regulation providers and new entrants. We would expect them to rely more on the tools of the marketplace to develop their "product"—investing in research, testing products in the market, collecting and analyzing data, retaining a wide variety of specialists—than on the (often weakly funded and weakly researched) governmental processes of hearings, committee meetings, and rule making that self-regulatory membership organizations often employ.

The regulation of the legal profession embodied in the United Kingdom's Legal Services Act of 2007 is an example of this new model: a publicly accountable and appointed body (the Legal Services Board, which must be dominated by nonlawyers) manages the designation and oversees the performance of private regulators. Any entity may apply to be an approved regulator. While the current set of eight approved regulators reflects significant continuation of historical models of self regulation by membership organizations engaged in differentiated activities—the Solicitors Regulatory Authority regulates solicitors and the Bar Council regulates barristers—it is clear that the new model will allow alternative regulators, which are not membership organizations, to seek approval and compete for the business of licensing practitioners. Indeed, the Institute for Legal Executives, which sets out an alternative non-University path to qualification to perform many of the same tasks historically performed by solicitors, although also a membership organization, is clearly a step in this direction. More generally, given the erosion of limitations on the scope of approved practice for members of these different legal

professions—barristers in England now may contract directly with clients and need not be retained exclusively by a solicitor, while solicitors and legal executives now may gain rights of audience in some higher level courts—these multiple professional bodies (as well as new entrants) can begin to compete and differentiate across training and regulatory requirements. This competition can reduce the need for excessive and expensive training of those who provide many legal services.

On the farthest horizon, we can envision a world in which specialized private regulatory services firms (not industry membership organizations) design and implement regulations in a wide variety of areas such as health care, environmental protection, intellectual property, product safety, and workplace conduct. In this world, public regulators—legislators and administrative agencies—could focus on identifying performance and outcome targets for regulation and monitor the success of the regulatory body at a relatively macro level. Private firms seeking status as approved regulators would have to demonstrate success in achieving regulatory objectives and would then compete for the business of those who require, in turn, regulatory approval.

What do we have to change to facilitate more market-based production of law?

Three essential changes are needed to move toward a greater role for market-based production of law:

1) Open legal markets to competition.
2) Develop a public-law framework for privately produced legal regimes.
3) Reduce barriers to trade in legal services.

I discuss each of these changes in turn.

1) Open legal markets to competition, initially by creating a federal licensing regime that will exempt legal services supplied to commer-

cial clients from state-by-state bar and state supreme court regulation.

Opening legal markets to competition requires a substantial shift in the U.S. regulatory environment. The current state-by-state regulatory regime is a major obstacle to reform. Not only is the potential for reform highly fragmented, it is dominated by the voting interests of individual lawyers (who, for example, can have a private interest in expanding the scope of unauthorized practice rules to protect market share) and the deliberative reasoning of those trained in legal analysis. The point that legal infrastructure is, in large part, economic infrastructure is one that a profession at least rhetorically organized around concepts of rights, justice, and due process is likely to have difficulty hearing. More importantly, state judiciaries and bar associations are not really designed to be policymaking institutions, much less economic policymaking institutions. They often lack full-time leadership (like law firm managing partners, most of those who participate in the leadership of bar associations continue their practice) and they lack expert policy staff and resources to devote to policy, particularly data collection and analysis.

At a substantive level, the state-by-state licensing regime limits the potential for significant innovation in legal production by limiting the mobility and scale of legal businesses. Although these limits are routinely ignored in large corporate practice and recent rule changes have softened their edges, on the books it is nonetheless an unauthorized practice of law for a New York lawyer to "practice law" on behalf of a California client or in Californian proceedings involving a New York client. This obviously limits the mobility of individual practitioners. Moreover, by burdening the achievement of scale in the distribution of legal services, state-by-state licensing has a significant impact on the development of innovations such as data-intensive methods for improving on the anecdotal judgment that now drives the human-capital intensive craft model of legal production. It also restricts the development of web-based tools to deliver legal services. Although online providers (such as LegalZoom and Intuit-

owned MyCorporation.com) can provide documents online and conduct guided interviews to assist users in the completion of the documents, these providers cannot enrich their offering with legal advice, either through data-driven analysis of interview answers or a "chat with a lawyer now!" link on the website. Not only would the provider have to be fully owned, managed, and financed by lawyers in order to provide that service, it would have to ensure that a client in Idaho only received advice from a lawyer licensed to practice in Idaho.

To open competition in legal markets, it is therefore critical to establish a national regulatory regime guided by both legal and economic policymakers. Preempting state regulation, perhaps initially for only subsets of lawyers (such as those providing services to corporations only), is a necessary step both to reduce the fragmentation of the industry and to shift regulation onto an economic policy–based footing. Such a regime should drop the requirement of lawyer ownership, control, and financing of legal businesses and sharply curtail the scope of activities for which formal legal training and bar admission is required. Arguably, business consumers of legal services—particularly larger businesses and those with expert in-house purchasers of these services—should not be under any limitation on who they can hire, domestic or foreign, to perform "legal" work. Where necessary, consumer protection can be much more carefully targeted than it is now; much of the consumer protection that lawyers' regulation now claims it seeks to provide can be provided by existing protections rooted in laws against false advertising, negligence, and related issues. Competition and differentiation in training and practices can be further encouraged by allowing multiple competing national bodies to provide accreditation and licensing where needed. And all limitations imposed on the practice of law by professional associations or accrediting bodies should be subject to ordinary application of antitrust law. Recent restructuring of the legal system in the United Kingdom, where many of these reforms have already been implemented, provides a useful model

for the development of a much more competitive and innovative legal market in the United States.

2) Develop a public-law framework for privately produced legal regimes.

Like markets for other goods and services, markets for legal goods and services require a legal framework in which to operate. To move in a policy direction toward a greater role for market-based production of legal goods and services (including formal rules and procedures) does not imply disconnecting entirely from public provision. It merely shifts the locus of public provision back a level, in the same way that the well-understood effort to "privatize" the production of steel in formerly communist states shifts the role of government upstream—out of the daily determination of production volumes and pricing and into the determination of ownership rights over a manufacturing facility, contract dispute resolution, and employment regulation.

In order to create a reasonably competitive market in private contract law systems, for example, we would require publicly provided law that recognized the authority of the private provider to be the exclusive provider of "contract law" for its customers. Note that this is more than providing contract terms: It means establishing the framework in which obligations and commitments become binding on the parties and the basis on which obligations and commitments are implemented, as well as the scope of the authority for the provider to act to manage and adjust the parties' relationship. It also requires enabling private providers to issue orders resolving a contractual dispute (examples include paying damages, delivering promised goods, participating in information exchanges, or resolution procedures) enforceable in state-provided courts. This is what the Federal Arbitration Act (FAA) in the United States accomplishes now: It makes an arbitrator's resolution of a case as effective as if it were resolved by a state court itself. Arguably this is all that we require of the public-law framework to make private contracting systems effective. The fact that we have yet to see robust private contracting providers in the nearly 100 years of experience with the FAA,

however, suggests that more may be needed to support the creation of such a system. Public law would have to make it clear, for example, that providing such a system is not an "unauthorized practice of law" (as some may argue is now the case under existing state-by-state professional regulation), enabling corporate entities with public financing and nonlawyer owners and managers to participate and to provide the service across state lines. That such restrictions have constricted the scope for arbitration as an alternative system is evident in the fact that in some cases arbitrators are required to be licensed attorneys,[17] and in many states lawyers have argued and state supreme courts have agreed that representing a party in an arbitration is "the practice of law" and hence nonlawyers and out-of-state lawyers may not provide this service.[18]

Building the framework to support a competitive market in bankruptcy law or corporate law would also seem to be relatively straightforward. In the case of bankruptcy, it would require federal courts to recognize bankruptcy contracts[19] as effectively displacing federally provided default rules. In the case of corporate governance, it would require individual states to recognize incorporation under a privately provided legal regime (governing, for example, duties of directors and meeting requirements) as being as effective as incorporation under the legal regime provided by another state. This would imply according the benefits of incorporation to those who chose the incorporation regime as against third parties, such as tort claimants (who would not be able to sue individual shareholders for their losses in the absence of reasons to pierce the corporate veil), and interpreting contractual or statutory obligations (such as taxes) based on corporate form or bank-

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[17] See FINRA, Code of Arbitration Procedure for Customer Disputes (FINRA Manual), §10211 available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4096.

[18] See, e.g., *Rappoport v. Florida Bar*, 540 U.S. 967 (2003); Florida Bar re Advisory Opinion on Non-Lawyer Representation in Securities Arbitration, 696 So.2d 1178, 1180 (Fla. 1997); Virginia State Bar, UPL Opinion 214 (April 8, 2008) available at http://www.vsb.org/site/regulation/upl-opinion-214.

[19] Alan Schwartz, "Contracting about Bankruptcy," *Journal of Law, Economics & Organization* 13 (1998): 127–146.

ruptcy status to apply equally to corporations formed, liquidated, or reorganized under private as well as under public legal rules.

It is conceivable that a market for privately provided corporate governance, bankruptcy, or contracting regimes would require some form of intellectual property protection to generate appropriate incentives to invest in potentially appropriable system design—as Ribstein (2010) argues.[20] And we should expect that a competitive market for private legal regimes would require the oversight of antitrust law and other regulations intended to balance market power or protect consumers against fraud. But these issues should be approached on the same terms that we approach them when we are deciding how best to structure and regulate private markets for ordinary economic goods and services, such as business consulting or computer operating systems.

The much harder case for public framework development arises when there are substantial public interests affected by the content of the private legal regime. Environmental regulations, for example, clearly cannot simply be shunted off to the elections made by the entities that would be subject to the regulation: With no political oversight, those regulations would quite predictably offer next to no environmental protection for the benefit of the public generally. But it is conceivable that we could design public law requirements for a private regime, such as a targeted level of industrial pollution. The key would be to allow and facilitate competition between regulatory bodies and minimize capture by regulated entities. We would also have to address the question of how "conflicts of law" would be resolved in these noncontractual settings where we cannot rely on a negotiated *ex ante* "choice of law" by all involved parties. (Compare, O'Hara, and Ribstein 2009). Understanding how to resolve these difficult design issues is probably beyond the reach of our existing state of knowledge—and the recent regulatory failures attributable in part to self regulation in the financial industry certainly emphasize how difficult the design problem is—but the prospect for building these

[20] Larry Ribstein, "The Death of Big Law," *Wisconsin Law Review* (forthcoming).

markets to better meet the demands of increasingly more complex economic activity is something that should be seriously addressed by policy analysis and debate.

3) Reduce barriers to trade in legal goods and services.

Just as domestic restrictions on the practice of law need to be dismantled in order to promote more competitive production of legal inputs, so too do international restrictions need to come down in order to support a truly global market for legal inputs. The global base for the economy and the fundamentally multijurisdictional nature of a growing share of economic activity makes reduction in the barriers to mobility of legal inputs a critical reform for the twenty-first century. But globalization of trade in legal services lags far behind globalization more generally. Most countries have strict local requirements that erect substantial barriers to entry by foreign providers. These restrictions significantly repress the economic incentives for legal practitioners to invest in the invention of transborder legal solutions to address the key feature of the globalizing economy.[21] General counsels of some of our most innovative companies complain that they have no choice but to rely on a "patchwork of providers" to resolve the multijurisdictional issues they face, often long before they achieve the kind of scale that could justify hiring armies of lawyers from different countries: today's innovative firms are "Global from Day One." And even when scale is not the problem, the absence of providers capable of developing solutions to multijurisdictional legal problems—such as those faced by Google distributing YouTube in more than 100 countries around the globe, each with its own laws on privacy, intellectual property, defamation, and national security—is a significant obstacle to growth and innovation.[22]

Around the world, domestic lawyers are protected by requirements that in order to provide services within their borders or on

[21] Hadfield, "The Role of International Law Firms."

[22] Hadfield, "Law for a Flat World."

issues related to domestic laws, they must possess a local law degree and pass a local qualifying examination (generally available only in domestic languages). Some countries impose citizenship or residency requirements, or demand that legal providers operate a physical office in the country (inhibiting electronic services). Local restrictions on advertising abound in the United States but they often are even more restrictive in other locations, preventing lawyers from advertising specialties, for example. The effect is to limit competition. Organizational restrictions—such as requirements that lawyers operate only in partnerships, preventing the employment of a lawyer by another lawyer, and prohibiting multiple offices—limit the capacity for growth of law firms to meet global demand. The European Union has reduced many of these barriers, prohibiting differential restriction on the practice of law by lawyers from one member country in another member country. But these benefits do not extend to countries outside the EU.

Domestically, an easy first step to globalizing legal markets would be to eliminate U.S. restrictions on the purchase of overseas legal services by U.S. corporations. This is emerging as a significant issue for U.S. companies as they increasingly seek to reduce burgeoning legal expenditures through the use of low-cost and data-intensive legal services provided by legal process outsourcers such as CPA Global, which is headquartered in the United Kingdom but maintains a large office performing legal support work in India. These companies review, organize, and draft documents, manage contracting processes, conduct legal research, prepare deposition summaries, and more. Currently, such outsourcing is required by state bar association rules to be channeled through and supervised by state-licensed lawyers. Again, federal law may be required to cut through this limitation, reducing the cost of supervision and expanding the availability of these low-cost services to small and medium-sized businesses that lack the in-house resources to perform supervision of offshore legal work.

Internationally, any efforts to open up U.S. markets to offshore providers should also seek reciprocal benefits in other countries. Legal services are covered by the General Agreement on Trade in Services (GATS), thus requiring WTO member states to take steps to ensure that licensing requirements are based on objective criteria and are not overly restrictive. Arguably, then, the framework is already in place to promote these efforts. But on the basis of the assertion that law is fundamentally political in nature and that the independence of the legal profession is a pillar of democratic governance, legal professions worldwide thus far have faced little difficulty protecting restrictive practices from scrutiny. This is why I emphasize that a large share of legal infrastructure is fundamentally economic infrastructure—distinct from the political components of a legal system that are indeed critical to effective democracy.

Summary

A clear recognition of the economic impact of legal policy is essential for the production of the legal infrastructure necessary to promote dynamic efficiency, innovation, and growth in a global economy. Having grown up largely under the stewardship of lawyers informed by distinctively legal analysis, and in the context of a far more stable, homogeneous, and vertically integrated economy, our existing legal infrastructure is increasingly ill suited to meet the needs of our new globalized and increasingly web-based economy. So long as we rely exclusively on lawyers, judges, bureaucrats, and politicians to design our legal rules, and allow lawyers to severely restrict competition in legal markets, we are unlikely to see the kind of entrepreneurial innovation in legal rules, practices, and procedures necessary to meet the rapidly changing demand for the legal inputs that structure and regulate activity in the new economy. A greater role for market-based production of legal inputs promises to harness greater resources and diverse ways of thinking about how to do what law aspires to do more effectively and at lower cost. Some of the reforms needed to open up our legal markets to the kind of competition we need are

relatively straightforward to identify and implement, such as eliminating the state-by-state restrictive regulation of legal markets by lawyers and judges who lack both the resources and the orientation (as well as the legitimacy) to approach the task as the problem of economic policy that it is. Other relatively straightforward reforms involve the facilitation of markets for privately provided regimes in areas such as commercial contracting, corporate governance, and bankruptcy. The broader challenges are to design the appropriate framework law to create and oversee competition among private regulatory bodies in a wider range of areas that reach beyond the contracting interests of commercial parties—to areas touching more directly on the public interest such as intellectual property, environmental regulation, and product safety. We should not be surprised if the task is daunting, however; the very reason the task is so necessary is that the complexity of the world that law structures and regulates is already outstripping the capacity of conventional political, bureaucratic, and judicial methods of producing law (as we have witnessed with recent efforts to reform the regulation of massively complex systems such as health care and the financial industry). Matching the radical innovations we have witnessed throughout the global economy, we need to find a way to harness the creativity and investment potential of markets to generate radical innovations in the production of law.