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LAW AS A BYPRODUCT: THEORIES OF PRIVATE LAW PRODUCTION

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ABSTRACT

Public lawmakers have weak incentives to engage in legal innovation. Private lawmaking is a potential solution to this problem. However, private lawmaking faces a dilemma: In order to be effective privately produced laws need to be publicly enacted, but under current law enactment eliminates the intellectual property rights that are essential to motivate private lawmakers. As a result, much private lawmaking is done as a byproduct of other activities. The mixed incentives entailed in this "byproduct" approach make it a second-best response to the problems of public lawmaking. Potential solutions involve finding a better balance between public access and private rights, perhaps through hybrid public-private lawmaking endeavors.

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Innovation is at least as important for lawmaking as it is for private enterprise. Innovation in lawmaking can increase social welfare even more than discrete enterprise innovations because a given lawmaking innovation can spur multiple private sector innovations. *Systemic* innovations in society's lawmaking apparatus could have a double-multiplier effect by encouraging welfare-enhancing laws (Butler & Ribstein). Yet policymakers have given little attention to lawmaking innovation as a potential source of growth.

Lawmaking has generally been considered the province of government agents subject to political control. Policymakers and scholars long have recognized the potential shortcomings of government-enacted laws. Powerful interest groups may successfully promote laws opposed by, or block laws favored by, society in general. Given these political pressures, Hadfield & Talley (HT) have shown that public lawmakers have weak incentives to produce socially valuable innovation. Although there is plenty of legal innovation, much of it directly favors powerful interest groups, particularly including lawyers. This raises the question whether there are alternative mechanisms for legal innovation that can bypass some of the problems with interest group politics.

One important counter to political "voice" is the opportunity created by multiple jurisdictions for individuals and firms to "exit" laws they do not like and choose laws they favor (O'Hara & Ribstein). However, even jurisdictional competition ultimately is constrained by the need to persuade governments to enact and, more importantly, enforce welfare-increasing innovations.

It is logical, therefore, to turn to the private sector as a potential way to fill the gaps in legal innovation left by government lawmaking. This paper's main contribution is showing that private parties' ability to usefully supplement public lawmaking depends on whether they have robust intellectual property rights in their creations. The problem is that while private parties can *draft* legal materials, only government agents can turn these materials into law. Thus, we distinguish private law*drafters,* who produce legal materials that may or may not become law, from law*makers,* whose products are adopted as law.

Private lawdrafters have intellectual property rights in their creations. For example, parties clearly may agree to a contract they expect a court to enforce whose language may be

protected under copyright law.[1] Authors also might profit by writing standard form contracts or general business plans that many firms can use. Because negotiating and writing a private contract can be costly, parties and firms may find it cheaper to pull a standard form off the shelf and adapt it for a specific use.

These purely private standard forms are not, however, as valuable as *laws*. We define the latter term to include provisions the state very likely to enforce because they are promulgated or approved by government (Snyder). The ability to enlist the state's enforcement framework makes law a valuable mechanism for reducing the substantial transaction costs entailed in obtaining comparable results through purely private contracting (Coase). Law also may be helpful for such purposes as providing a focal point for the development of a large body of cases and enforcing deals made under particular standard forms, particularly against parties who did not explicitly agree to the terms of the deal (Ribstein (1995); Snyder).

Given the need for government involvement to produce the effect of law, private lawdrafters must accept the restrictions associated with that involvement. In particular, fairness and due process considerations demand giving people rights to copy and use the laws they must obey, and therefore relaxing private property rights in these materials. Thus, once a legislature or court makes private materials into law, the producers of these materials lose intellectual property rights in their creations.[2] It follows that legal innovators must accept the risk their property rights will be limited if they achieve their goal of creating law. In short, private lawdrafters face a Hobson's choice between weak rights in the valuable property of law, or stronger rights in the less valuable property of non-law.

Given limitations on private lawmaking, private parties' involvement in lawmaking occurs almost exclusively as a byproduct of other activities from which private parties can reap mostly political rewards based other than on sales in a market for laws. For example, litigants produce precedents, but only as a byproduct of dispute resolution; trade groups produce and lobby for laws that serve the group's and not society's interests; lawyers participate in lawmaking to enhance their own reputations or those of the states in which they are licensed to practice law; and the National Conference of Commissioners on Uniform State Laws (NCCUSL) produces law as a mechanism for cartelizing state laws.

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[1] *See* American Family Life Insurance Co. of Columbus v. Assurant, Inc., 2006 WL 4017651 (N.D.Ga., January 11, 2006) (holding that plaintiff's "narrative" style insurance policy may be protectable under copyright law); NIMMER ON COPYRIGHT § 2.18[E] (noting that "there appear to be no valid grounds why legal forms such as contracts, insurance policies, pleadings and other legal documents should not be protected under the law of copyright."); Kenneth A. Adams, *Copyright and the Contract Drafter*, N.Y. L. J., Aug. 23, 2006, at 4.

[2] *See* Building Officials & Code Administration v. Code Technology, Inc., 628 F.2d 730 (1st Cir. 1980); Veeck v. Southern Building Code Congress International, 293 F.3d 791 (5th Cir. 2002, en banc); Kobayashi & Ribstein (2011).

The legal innovation resulting from this byproduct process is likely to have less social value than what would be produced by innovators who have property rights in their innovations and can share in the full social gain the innovation produces. The byproduct approach enables innovators to share only indirectly in that gain, and then only in a few relatively narrow situations. Innovation may come at the cost of enhancing the political power of a particular interest group, such as lawyers. This may mean that byproduct private lawmaking often shares with public lawmaking some of the problems of the political process.

We propose ways to encourage private law innovations by better balancing the need to preserve public access to law against the need to provide more robust property rights in legal innovation. In other words, we consider how to move private creation of law from *byproduct* to *product*. This could include such mechanisms as combining patent or copyright with a mandatory limited license and combining property rights with restricted access in privatized systems.

Part I presents a model of public and private lawmaking which articulates the basic tradeoffs involved, particularly including the key role of property rights in law. The remainder of the article elaborates on the elements of the model. Part II discusses the problems inherent in purely public lawmaking that call for supplementing this approach with private law. Part III discusses existing approaches to private lawmaking which focus on lawmaking as a byproduct of other activities. Part IV discusses changes in the legal infrastructure that could encourage innovation by private lawmakers. Part V concludes.

I. A MODEL OF LAWMAKING

This section develops a model of lawmaking that illustrates the importance of property rights in law. Our model derives from the one presented by Hadfield & Talley. Like HT, we focus on business association contracts, but our model can be generalized to include other types of contracts. Subpart A presents the basic model of socially optimal legal innovation. This subpart assumes that provisions appear without considering parties' incentives to produce these provisions. Subparts B and C vary the basic model by introducing intellectual property rights, which help determine parties' incentives to produce legal innovations. Subpart D highlights the Hobson's choice inherent in this analysis of legal innovation between creating products that have little or no market value because of uncertainty as to enforcement, and creating more valuable laws in which the creators have weak or no property rights.

A. BASIC MODEL: MISMATCH AND UNCERTAINTY

This subpart presents a model of optimal legal innovation. Like HT we assume that an individual firm j has an ideal structure x_j and that firms are distributed uniformly, with $x \in [0,1]$.[3]

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[3] In contrast to HT, our model assumes for simplicity and expositional clarity that firms' ideal points are

Firm j's structure x_j represents the firm's optimal organizational structure, which might include such elements as tax treatment, limited liability and type of management. This subpart varies one of HT's implicit assumptions, that privately produced provisions are equivalent to provisions adopted as law. Subparts B and C vary HT's other implicit assumption, that private lawdrafters have property rights in their products.

Private lawdrafters can create sets of provisions that government lawmakers might adopt as "law." We use this term to mean a rule that predicts how a court will act. Thus Snyder (373) cites Holmes' (1896 at 458) statement that "a legal duty so called is nothing but a prediction that if a man does or omits certain things he will be made to suffer in this or that way by judgment of the court;-and so of a legal right." We assume statues adopted as law by a legislature or court are enforced with probability $\phi = 1$ and that privately produced provisions not so adopted have a probability of enforcement $\phi \leq 1$.

Laws impose mismatch costs on firms that organize under the law. The costs of organizing firm j under provisions with characteristics $a_{i,}$ are $\tau(a_i - x_j)^2$. The transaction cost τ represents the costs to each firm (x_j) of either operating under or contracting around default provisions (a_i) that do not perfectly fit the parties' needs. Following HT, we adopt a quadratic mismatch cost function, so these costs rise at an increasing rate as the firm's ideal point x_i moves away from provisions included in a_i.

If there is no statute at $a_i \in [0,1]$, we assume the firm can operate under an existing statute E located outside this interval. Mismatch costs will equal $M\tau$, where $M > 1$. All firms would prefer organizing under a new statute $a_i \in [0,1]$ to organizing under the existing statute E. The value of the statute to firm j is the firm's reduced costs of organizing and operating under the statute located at a_i. In other words, $K = \tau[M - (a_i - x_j)^2]$.[4] If $M > 1$, $K > 0$, so a firm with ideal point $x_j \in [0,1]$ will strictly prefer to organize and operate under a new statute at $a_i \in [0,1]$ to forming under an existing statute at $a_E \notin [0,1]$. This new statute accordingly may be a social wealth-enhancing innovation.[5]

Privately produced provisions can impose not only the mismatch costs identified above, which are incurred with probability ϕ, but also reorganization cost R when the provisions

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uniformly distributed, and that there is no uncertainty with respect to the actual distribution of firms' ideal points. This difference does not alter main HT implications cited in this Section.

[4] HT do not explicitly derive K, and assume that K is large so that the net benefits of adopting a statute at a_i are positive.

[5] Even if increasing the number of statutes reduces mismatch costs it might increase total social costs because an excessive number of forms can increase transaction costs. See Merrill & Smith. We do not address this issue. However, it is worth noting that in the context of business association and other contractual standard forms, parties' ability to choose the applicable form likely minimizes the problem Merrill & Smith analyze. Moreover, legal innovation can reduce as well as increase the problem of excessive forms, as where the new statute reduces the costs of choosing standard form rules. See Ribstein (2003).

adopted by the firm are not enforced. The firm then will incur higher costs equal to $R\tau$, where $R > M > 1$. These higher costs, which occur with probability $1-\phi$, can include the costs of disruption and legal penalties and liability. We assume these costs are higher than the mismatch costs M of organizing under an existing statute at a_E. A firm's expected costs of organization and operation using privately produced provisions accordingly equals $\phi\tau(a_i - x_j)^2 + (1-\phi)R\tau$. It follows that, unlike adding a *statute* at $a_i \in [0,1]$, firms will not strictly prefer a *private* provision at $a_i \in [0,1]$ to operating and organizing under the existing statute at a_E. As discussed below in subpart D, there is a critical enforcement probability below which firms will prefer statute a_E over private provision a_i.

Table 1 summarizes the costs imposed on firms that organize under a statute versus under a privately produced set of provisions.

TABLE 1 – COST OF ORGANIZATION

Firm with Ideal Point x_j

	Expected Mismatch Costs	*Expected Reorganization Costs*	*Expected Total Costs*
1. Operate Under existing statute $a_E \notin [0,1]$ ($\phi = 1$)	$M\tau$, $M > 1$	0	$M\tau$
2. Operate Under a Privately Produced Set of Provisions $a_i \in [0,1]$ Not Adopted as Law ($\phi \leq 1$)	$\phi\tau(a_i - x_j)^2$	$(1-\phi)R\tau(a_i - x_j)^2$, $R > 1$	$[\phi + (1-\phi)R\tau](a_i - x_j)^2$
3. Operate Under a Statute at $a_i \in [0,1]$ ($\phi = 1$) (HT cost function)	$\tau(a_i - x_j)^2$	0	$\tau(a_i - x_j)^2$

To see the distinction between mismatch and reorganization costs, consider a Firm j with ideal point x_j that can organize under perfectly matched provisions $a_i = x_j$. This firm's mismatch costs are zero. If these provisions are enacted as *law*, we assume a zero probability that the firm will have to incur reorganization costs.[6] As a result, the firm's total mismatch and reorganization

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[6] The assumption that of zero probability that the firm operating under a statute will have to incur reorganization costs (i.e., that $\phi = 1$) simplifies the mathematics but is not necessary for our main results. Even if such firms face a positive probability of having to incur reorganization costs ($(1-\phi) > 0$) our results follow as long as

costs are zero when it adopts the statute. If the same firm adopts identical provisions that have not been adopted as law it will face no mismatch costs but positive expected reorganization costs.

Thus, consider a Firm j that wants the features of a modern limited liability company (LLC) of limited liability, partnership taxation and centralized management prior to the promulgation of state LLC statues. Firm j's ideal point x_j includes features that differ from existing general partnership provisions at a_E. An LLC-type firm that operates under existing general partnership provisions will incur high mismatch costs $M\tau$ because it will be forced to forgo either limited liability or partnership taxation, but no expected reorganization costs (Row 1 in Table 1).

If Firm j decides to adopt privately produced provisions at a_i that have the above characteristics of an LLC, the firm must bear the mismatch costs of drafting around default provisions that do not match or operating with imperfectly matching provisions. For example, a firm with an ideal structure that includes the partitioned limited liability of a series LLCs may have to operate under an LLC statute that does not recognize series LLCs. If the firm forms and operates in a jurisdiction that has not adopted an LLC statute it will also face expected reorganization costs when some of its ideal provisions are not enforced. For example, the firm's members may face personal liability or additional taxes and penalties because the firm was not able to use partnership taxation. These costs are in addition to the mismatch costs of forming and operating under a_i (Row 2 of Table 1). But if Firm j forms in a state that has adopted an LLC statute containing provisions a_j the firm would not have to bear to costs related to the uncertain enforcement of LLC terms. This firm bears only mismatch costs and not expected reorganization costs (Row 3 of Table 1).

Finally, a public lawmaker can maximize social welfare under these conditions by locating N statutes along the interval [0,1] in order to minimize firms' mismatch costs. This will be achieved by locating the N statutes at even intervals [1/2N, 3/2N, 5/2N, … (N-1)/2N]. For example, if the government promulgates two statutes, then it should locate them at $a_1 = ¼$, $a_2 = ¾$. The optimal number of statutes N* increases until the marginal transaction cost savings of an additional statute is less than the cost of drafting and promulgating the statute (F). This occurs when $\tau/(12N^*(N^*+1)) < F$. This social welfare effect is maximized if firms can use the statutes for free.

B. PRIVATE INCENTIVES WITH INTELLECTUAL PROPERTY PROTECTION

This section analyzes private lawdrafters' incentives to produce legal materials that have the effect of laws (i.e., provisions that are enforced with probability $\phi = 1$) *and* can be protected

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this probability is lower that the one that would apply if the firm adopted identical provisions that have not been adopted as law.

by intellectual property. Here private law*drafters* are in effect private law*makers*. This is the situation HT implicitly assume. Under these assumptions, private lawmakers can maximize profits by choosing both where to locate the statute a_i and the price p_i to charge for use of the statute. HT show that where private lawmakers create two statutes and firms are distributed uniformly the authors will maximally differentiate the statutes (that is, locate them at $a_1 = 0$ and $a_2 = 1$) and price them at τ more than the marginal cost of selling the statute.

Two opposing factors in HT's model determine private lawdrafters' choice of location and the location's effect on profits. On the one hand, given the first author's choice of location, the second author's moving toward the first statute increases the number of firms that use and pay for the statute. On the other hand, this move decreases the equilibrium price that firms will pay for using the statute. HT show that, under the specified conditions, the negative effect on price dominates the positive effect on quantity. Thus, private authors have an incentive to move away from each other when choosing the location of their statute.

HT present a model in which public legislators have no incentive to innovate after state profits reach a certain level, and therefore no incentive to differentiate their statutes' price and location. HT also show that, from a welfare standpoint, while outcomes under both public and private provision of law differ from first-best results derived in subpart A, the extreme differentiation produced by private production of statutes weakly dominates the undifferentiated outcome that results from the public production of statutes. In other words, the differentiated private outcome is either equivalent or strictly preferred to the undifferentiated public provision outcome.

C. PRIVATE INCENTIVES WITHOUT INTELLECTUAL PROPERTY FOR LAW

The model with a market for privately produced law protected by intellectual property provides a useful benchmark for demonstrating our main thesis regarding the importance of property rights in law. Our model makes assumptions about law and intellectual property that we argue also are implicit in HT's model. First, HT assume that privately drafted provisions are equivalent to public statutes in the sense that both are law and certainly enforced ($\phi = 1$). Thus, the total costs of HT private laws are equal to the quadratic mismatch costs listed in Row 3 of Table 1. However, this is inconsistent with the fact that only government agents can adopt laws. Second, HT assume that private authors are price setters who can appropriate the returns from their work. However, as noted above,[7] this assumption does not hold under current law because copyright law does not protect privately produced models that are adopted as law. This subpart considers the result of incorporating more reasonable assumptions about intellectual property rights in law into the model.

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[7] *See supra* note 2 and accompanying text.

Given their weak copyright protection in law, private lawmakers (that is, drafters of provisions that are adopted as law) face free riding by potential users of their work and competing jurisdictions. As a result there will be highly elastic demand for their product such that even a slight increase in price will sharply reduce demand. Private lawmakers will be unable to set prices as HT assume. More precisely, any demand for a copy of any privately produced statute would be based on differences between potential users' costs of access to the statute (δ), which would likely be constant across firms and statutes. Under these circumstances, the demand for a set of provisions a_i would be perfectly elastic at $p_i = \delta$.

Private lawmakers who cannot set price lack incentives to innovate by differentiating products. Recall that HT's differentiation result occurs because the positive marginal price effect of this differentiation on profits dominates that of reducing the number of firms adopting the statute. If there are no positive price effects because the lawmakers are price-takers facing perfectly elastic demand curves, output effects, which disfavor differentiation, will dominate. In a two-statute model, private lawmaking under price taking will result in the same outcome (undifferentiated statutes) as public provision.

To see this point explicitly, consider the incentives of a private lawdrafter (a drafter of a set of provisions a_i where $\phi = 1$) that is a price-taker in the sense that it cannot set the price of its product because it lacks intellectual property rights. The absence of property rights allows imitators and potential users to free-ride on drafting firms' investments, and therefore to sell or use the same products without having to incur drafting costs or compensate the statute's author. Given $a_1 < a_2$, (that is, a_1 is closer to 0 in the ideal point space x), the first private lawmaker's choice of location a_1 will result in firms with ideal points between 0 and x* choosing to organize under a_1.[8] Demand for a_1 equals:

$$x^* \equiv (a_1 + a_2)/2 + (p_2 - p_1)/(2\tau(a_2 - a_1)).$$

Profits of private lawmaker 1 would equal

$$\Pi_1 = (p_1 - c)x^* - D = (p_1 - c)[(a_1 + a_2)/2 + (p_2 - p_1)/(2\tau(a_2 - a_1)] - D$$

where c is the cost of distributing a copy of the privately produced statute and D is the upfront cost of drafting the statute.

The expected demand for private lawmaker 2 would equal 1 – x*, and its profits would equal:

$$\Pi_2 = (p_2 - c)(1 - x^*) - D = (p_2 - c)[1 - (a_1 + a_2)/2 - (p_2 - p_1)/(2\tau(a_2 - a_1)] - D$$

[8] More precisely, expected demand for private lawmaker 1's model will equal F(x*), the distribution function of firms evaluated at x*. With a uniform distribution, F(x*) = x*.

A price-taking private lawmaker will choose statute location a_i that maximizes profits given price. This occurs when the statutes are optimally located at the point where the lawmakers cannot increase marginal profits by moving toward or away from their competitor's location. This condition is satisfied when the partial derivative of profits with respect to location a_i equals zero. However, these first order conditions are never satisfied when $p_2 = p_1 = \delta$:

$$\partial\Pi_1/\partial a_1 = (p_1 - c)[1/2 + (p_2 - p_1)/(2\tau(a_2 - a_1)^2] = (p1 - c)/2 > 0.$$

$$\partial\Pi_2/\partial a_2 = (p_2 - c)[-1/2 - (p_2 - p_1)/(2\tau(a_2 - a_1)^2] = -(p2 - c)/2 < 0.$$

It is critical to note that if $p_2 = p_1 = \delta$, private lawmakers cannot maximize profits by choosing different locations. Under these conditions, profits for private lawmaking firm 1 are increasing in a_1 while profits for private lawmaking firm 2 are decreasing in $a_{2,}$ with the result that both private lawmaking firms would locate at a single point, $a_1 = a_2 = ½$. It follows that if private lawmakers face a perfectly elastic demand curve and cannot set price, their incentive to differentiate will be as weak as that of HT public lawmakers.

If the private lawmakers are efficient at distributing copies of their statutes, so that $\delta > c$, profits, even net of the costs of drafting D, may be positive if competition does not drive prices to costs. However, the lack of property rights allows not only users but also competing providers to free ride. Thus, the absence of enforceable property rights forces the price of p_1 and p_2 not just toward δ but also towards c. Private lawmakers accordingly will not produce any statutes because their expected revenues will not cover their drafting costs D. This, in turn, leaves firms without suitable private forms and forces them to incur the mismatch costs $M\tau$ of forming under the existing law a_E.

D. THE HOBSON'S CHOICE: LAW WITHOUT IP OR IP WITHOUT LAW

The above analysis shows that private lawdrafters are confronted with a Hobson's choice. On the one hand, the assumed possibility that the private model law's terms will not be enforced raises the expected cost of using the model law and thus reduces the price firms are willing to pay for the term. On the other hand, court enforcement or interpretation of the contract terms increases the form's value but jeopardizes the author's property rights in it because the contract enters the public domain.

To examine this tradeoff in more detail, consider a set of provisions that has not been adopted as law. As noted above, firms will always prefer a privately or publicly produced statute (where $\phi = 1$) at $a_i \in [0,1]$ to organizing and operating under an existing statute at a_E because mismatch costs are smaller *and* the expected costs of reorganization $(1 - \phi)R\tau$ are zero. However, for privately produced provisions at a_i that have not been adopted as law, the probability that these provisions will be effective as written is less than one. From Table 1, when

$\phi < 1$ a firm's expected costs of organizing will equal $\phi\tau(a_i - x_j)^2 + (1- \phi)R\tau$. Thus, K, the marginal value of adopting a_i instead of a_E will be negative when

$$\phi\tau(a_i - x_j)^2 + (1- \phi)R\tau > M\tau$$

or, equivalently, when:

$$(1- \phi)R\tau > [M - \phi(a_i - x_j)^2]\tau.$$

The above condition shows that K will be negative when the expected costs of reorganization (the term on the left hand side of the inequality) exceed the expected reduction in mismatch costs (the term to the right of the inequality). Moreover, the existing statute at a_E will be preferred by firm j to the set of private provisions at $a_i \in [0,1]$ when

$$\phi < \phi^c \equiv [R - M]/[R - (a_i - x_j)^2].$$

Thus, the value K of a privately produced set of non-law provisions becomes negative for a firm with ideal point x_j when the probability of enforcement ϕ is below the critical value ϕ^c. If $\phi < [R - M]/R$, even the firm with an ideal point at $x_j = a_i$ will prefer to form and organize under the existing mismatched statute a_E. K will then be negative for all firms with $x_i \in [0,1]$, and the demand for the privately produced set of provisions at a_i will equal zero. As a result, even with enforceable property rights, private lawdrafters have no incentive to incur the costs (D) of producing non-law provisions.

More generally, if R is large relative to M, the critical probability ϕ^c will approach 1, so even small amounts of uncertainty regarding the enforcement of the provisions at a_i will cause demand for the set of provisions to fall. Again, even assuming enforceable property rights, the demand for a private law or statute will be less than that assumed in the model for privately produced provisions that have the characteristics of law.

To illustrate the other half of the Hobson's choice facing private lawdrafters, suppose that the author successfully lobbies a legislature to adopt its set of provisions a_i as law in order to increase ϕ. If the lawdrafter can continue to enforce its intellectual property rights, adoption as law will increase the demand for this set of provisions. However, under current law discussed above, adoption of the privately produced set of provisions as a public statute effectively costs the lawdrafter its copyright protection. Individual firms, other jurisdictions, and other providers could then adopt or sell the set of provisions contained in a_i without having to pay a licensing fee. As discussed above, the private lawdrafter whose work is adopted as law effectively becomes a price-taker, and the market price of its product is driven to the cost of distribution c. Again, as shown above, the lack of property rights negates incentives to incur the costs (D) of producing a model statute.

In short, the rewards from private authorship of a set of provisions a_i in the absence of effective property rights protection are negatively correlated with the degree to which the lawmaking results in products that have the most valuable feature of certain enforcement we attribute to law. Given these limitations on property rights in law, the price-taker model that applies to *public* lawmakers also most accurately describes the incentives of a *private* author who attempts to become a private lawmaker.

Finally, it is important to emphasize that the above analysis of both private and public lawmaking assumes that lawdrafters, like other creators of intellectual property, are seeking to maximize profits from the sale of their inventions. However, lawmakers may act as agents for interest groups who are trying to use the political process to engineer wealth transfers. As discussed below in Part III, this applies not only to public lawmakers, but also to most private lawdrafters under the "byproduct" theory of lawmaking. Taking these incentives into account would affect the location of proposed laws. Since these incentives exist for both public lawmakers and "byproduct" private lawdrafters, they may not affect the welfare tradeoffs between private and public lawmakers in a predictable way without further assumptions regarding the specific nature of byproduct lawmaking. However, they may affect the choice between public lawmaking and the purely private lawmaking discussed below in Part IV.

II. PUBLIC LAWMAKING

The remainder of the paper elaborates on specific elements of the tradeoffs involved in public and private lawmaking inherent in the above model. Public lawmaking entails a political competition among interest groups (Becker). Legislators compete for interest group support in order to obtain funds for reelection. Lawmakers have an incentive to innovate in order to attract or avoid losing interest group support. Interest groups, in turn, are motivated to some extent by the benefits their political entity earns when innovative laws attract revenues and residents from other states in interstate competition (O'Hara & Ribstein).

Innovation by political entities ultimately depends on the incentives both of the entities themselves and of the individual politicians who produce the laws. Examination of these incentives indicates that innovation by public lawmakers may be limited. First, even if a legislator can obtain state enactment of a law, the law may not help the state increase its revenues because the law is not welfare-enhancing or the state cannot capture the benefits of any increased welfare the law produces. Even a high quality and innovative new standard business form may face insuperable competition from a dominant existing law, such as Delaware's corporate law, which is entrenched by a network of case law, practices, forms and explanatory material (Klausner) or a high-quality legal infrastructure that other jurisdictions cannot readily replicate. Also, because states lack property rights in their laws, they may not be able to gain enough from making the law competitive to justify investing in innovation.

Second, and perhaps most important for present purposes, Part I shows that even if states have incentives to enact efficient and innovative statutes, individual legislators may have weak incentives to produce these statutes (Rose-Ackerman; Cumming & MacIntosh). Although legislators might be able to attract support by spearheading a very successful law reform, anything less than this level of success probably would not be enough galvanize interest group support for the legislator. At the same time, innovative legislators risk reputational harm from failed experiments and backlash from interest groups that are injured by the innovation.

Given states' and public lawmakers' weak incentives, public lawmaking will result in little innovation and substantial state uniformity consistent with HT's model discussed above. For example, there is evidence that state corporation laws tend toward uniformity (Romano 1985) and that states do not gain out-of-state formations from adopting innovative LLC statutory provisions (Kobayashi & Ribstein (2010). These studies indicate that successful competition depends more on a state's legal infrastructure than on its laws.

Although innovation does not seem to give states an edge in interstate competition, there is nevertheless significant statutory variation. This may be because legislators have incentives to engage in social wealth-reducing innovation at the behest of powerful interest groups. Lawyers in particular have political power resulting from their control of the judiciary and the organizational advantages which likely has tilted many aspects of the law in lawyers' favor (Barton). This leads to innovations that complicate the law and thereby create business for lawyers while imposing costs on the rest of society (Hadfield).

The deficiencies of public lawmaking raise the question whether systemic changes might increase the amount and quality of laws created by private parties. The next two Parts investigate this issue by looking more closely at two types of privately produced law.

III. LAW AS A BYPRODUCT

Legal innovation does not depend completely on the incentives of government-employed politicians and courts. Private parties also may have incentives to engage directly in drafting proposed laws. Part I shows that the critical problem with private lawdrafting is the lack of incentives resulting from private lawdrafters' need to choose between producing low-value non-law and inability to capture the benefits from high-value law. This Part shows that non-politicians have a third choice of engaging in legal innovation as a byproduct of other activities. However, the side incentives that motivate "byproduct" lawdrafting skew the content of these proposals from what private lawdrafters would produce if they could reap benefits from selling their innovations directly to users. Thus, the byproduct approach may decrease social welfare compared to a direct property rights approach by serving as a mechanism for the same sort of zero-sum political wealth transfers made by public legislators.

A. LITIGANTS AS LAWMAKERS

Parties to private litigation in effect contribute to legal innovation as a byproduct of their disputes when these disputes are resolved via judicial decisions. Litigants may have to incur extra court and attorney fees to support the production of formal legal opinions. Yet since judicial decisions are law, the litigants do not receive property rights in return for their investments in litigation. Courts[9] and state legislatures[10] have resisted litigants' efforts to restrict public access to these public proceedings through confidentiality agreements and protective orders. Litigants nevertheless generally may be willing to bear these costs as the price of better law and decision-making. The resulting process accordingly may be an efficient mechanism for creating law (Rubin) even if it is a byproduct of the separate activity of dispute resolution. However, use of this process is limited by the fact that the extra costs of producing judicial decisions plus the potential loss of confidentiality often induces the parties to settle (Kobayashi; Lederman; Friedman & Wickelgren; Fiss) or engage in private arbitration rather than try the case.

The common law may be the byproduct not only of ordinary litigants seeking only to resolve their disputes, but also of interest groups actively seeking to make law (Rubin and Bailey). This is closer to the sort of byproduct lawmaking discussed below in this Part -- that is, lawmaking whose welfare effects are skewed by the parties' incentives.

Another type of litigants involved in creating law is class action plaintiffs. Given class members' presumed inability to coordinate, the key interested party is the lawyer who instigates suit on behalf of the class. Indeed, a prominent former class action lawyer, William Lerach, famously bragged that he had no clients. Class action lawyers are essentially entrepreneurs using litigation to create an asset in the form of a recovery or settlement. They have a distinct interest in crafting and pursuing new types of causes of action, and therefore in creating law (Kobayashi & Ribstein (2004)). This, too, is closer to the other categories of byproduct lawmaking discussed below in that, unlike purely private law producers, class action lawyers seek personal advantage in the form of fees in the case rather than selling their "products" in a private market for new standard forms.

B. LAWYERS AS LAWMAKERS

Lawyers play an important role in state lawmaking.[11] There is significant evidence of lawyers' participation in lawmaking activities (Macey & Miller; Goforth). Moreover, lawyer

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[9] *See* Miller. For cases refusing to seal court records, *see* Brown v. Advantage Eng'g, Inc., 960 F.2d 1013, 1014 (11th Cir. 1992); Wilson v. Am. Motors Corp., 759 F.2d 1568 (11th Cir. 1985).

[10] *See* Florida's Sunshine in Litigation Act, FLA. STAT. ANN. § 69.081 (prohibiting orders that conceal information relating to "public hazards"; Texas Supreme Court Rule 76a (creating a presumption that court records, including unfiled discovery materials and settlement agreements, are open to the public); Miller at 443 (listing enacted and proposed state statutes and rules); Doggett & Mucchetti.

[11] Lawyers also engage in lawmaking directly through their compensated work on behalf of clients. When

professional rules establish lawyers' "participation in activities for improving the law, the legal system or the legal profession" as a professional norm (Model Rules of Prof'l Conduct Rule 6.1(b)(3)).

Lawyers' work as lawmakers is a byproduct of their other professional activity. Lawyers have special advantages as lawmakers, including their legal expertise and membership in bar associations which help coordinate lawyers' political activity. Lawyers also can earn reputational advantages from using their law reform work to advertise their expertise, and can influence the application and interpretation of law by doing remunerative or reputation-building work writing forms, manuals, and treatises.

Lawyer licensing by each state helps motivate lawyers to engage in legal innovation. Licensing gives lawyers a kind of informal property right in their licensing state's law by conferring an exclusive right to represent clients in the licensing state and to practice in that state's courts (Ribstein 2004). These rights enable lawyers licensed in a particular state to share in legal innovations' benefits of attracting people to locate in the state and litigate in the state's courts. State choice of law rules enhance the effect of licensing by linking the application of a state's law to whether the client resides in, or litigates in the courts of, the licensing state (O'Hara & Ribstein). The combination of lawyer licensing and choice of law rules rewards lawyers for engaging in lawmaking by forcing clients to pay for monopoly prices for legal services. Licensing complements the reputational and other benefits discussed above by encouraging lawyers to seek these benefits through lawmaking efforts rather than in other ways.

The main question for present purposes is the extent to which lawyers' byproduct incentives skew their interests away from social welfare. Licensing and reputation effects give lawyers some incentive to engage in efficiency-enhancing innovation. Like the state as a whole, lawyers want to attract people to the state. Accordingly, they have an incentive to adopt welfare-increasing laws rather than simply transferring wealth from clients to lawyers. This incentive of Delaware lawyers, for example, helps maintain the "bond" Delaware offers firms that incorporate in the state (Romano). The individual reputation benefit lawyers earn from lawmaking means that, unlike legislators, they will not be deterred from innovating by the risk that other states will copy their laws or that non-lawyer interest groups will oppose them.

The problem with lawyer lawmaking is that while licensing encourages lawyers to participate in lawmaking it also empowers them to influence the resulting laws so that they favor lawyers' interests. Unlike sellers who profit from sales of their products and therefore seek to tailor their laws to buyers' demands, lawyer-lawmakers have a particular interest in laws favoring lawyers. For example, it has been argued that Delaware lawyers seek to make Delaware law excessively lawyer-friendly (Macey & Miller). More generally, lawyers arguably seek

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they are acting only as agents whose interests are aligned with those of clients, lawyers are part of the interest group efforts discussed below in subpart C.

excessively complex laws that increase the need for and cost of lawyers (Hadfield; Barton), or laws that directly enhance the value of a law license by excluding non-lawyers from various types of legal work (Barton).

The extent to which lawyers' lawmaking skews laws from social welfare depends on how much these laws are disciplined by jurisdictional competition. Laws promoting litigation may help tort lawyers who can draw out-of-state defendants into pro-litigation courts while hurting transactional lawyers whose clients can choose where to reside depending on the applicable law (O'Hara & Ribstein). Lawyers' incentives accordingly may depend to some extent on the nature of their practice. On the other hand, lawyers may choose objectives that maximize the political power of lawyers generally. For example, most lawyers benefit from legal complexity even if lawyers' interests differ on other issues.

The above analysis of lawyers as lawmakers assumes lawyers will continue to engage in the same type of work they have in the past. However, significant changes are occurring in law practice, particularly including the rise of global and multidisciplinary practice and a market for "legal information" packaged in products or traded by participants in capital markets (Kobayashi & Ribstein (2011)). These developments could reshape lawyers' political power, in part by eroding lawyer licensing. This could remove an important source of private "byproduct" lawmaking. Also, if the market develops new types of private laws, this could reduce the need for "byproduct" lawmaking.

C. UNIFORM LAWS

A particularly influential lawmaking group is the official promulgator of uniform law proposals in the U.S., the National Conference of Commissioners on Uniform State Laws (NCCUSL). Law drafting is a byproduct of NCCUSL's main objective, which is lobbying by its politically connected members for state law uniformity. NCCUSL was organized during the nineteenth-century codification boom, when legislators sought to reduce legal disorder as well as to protect their authority from competition by other states and growth of the "federal common law" (Ribstein & Kobayashi at 135-36). NCCUSL's motto, featured on its web page (http://www.uniformlaws.org/) is "Diversity of thought, uniformity of law."

The fact that NCCUSL's lawmaking is a byproduct of its uniformity objective skews its products in two important ways from what would be produced by a full-fledged private market for law. First, NCCUSL not only does not seek to produce legal innovation, but in a sense actively tries to squelch it. NCCUSL is organized to promote a state lawmaking cartel that protects states from sister state competition that could erode politicians' ability to engage in rent-seeking.

Second, NCCUSL's structure, which has been designed to further its uniformity objective, deters efficient innovation by encouraging inefficient byproduct lawmaking

(Kobayashi & Ribstein 2009). NCCUSL is organized as a private legislature with representatives from every state. This enables NCCUSL to reflect all states' views in its uniform law proposals and present at least the appearance of political legitimacy. But it also forces NCCUSL to delegate responsibility for drafting its laws to drafting committees that are small enough to be able to agree on specific language. The drafting committees, in turn, are the venue for interest group negotiations (Kobayashi & Ribstein 2009). Many NCCUSL committee members undertake time-consuming drafting work because they represent interest groups that are seeking to gain from having NCCUSL lobby for their specific interests or positions (Ribstein & Kobayashi).

In addition to the unique lawmaking problems added by the uniform lawmaking process, NCCUSL enhances lawyers' lawmaking powers discussed above. NCCUSL was founded by the ABA as part of lawyers' move to gain respect and power for the legal profession (Friedman). Lawyers exercise power in NCCUSL as both part of the general legislative body and advisers to the drafting committee. This may help explain the complexity, vagueness and mandatory nature of uniform laws, which maximize the need for legal advice, drafting and planning (Ribstein & Kobayashi, 143-44).

D. LAWMAKING BY INTEREST GROUPS

Interest groups can write law themselves rather than supporting or rewarding legislators who engage in this activity. In this situation, the law can be considered a byproduct of the interest group's lobbying effort. The fact that interest groups sometimes bear drafting costs may increase the amount of innovation in the public lawmaking process. The tradeoff is that any innovation added by a law-drafting group reflects the interests of that group, and therefore may enhance rather than reduce rent-seeking.

E. INDUSTRY GROUPS

Industry groups engage in writing model law proposals and codes designed to deal with problems specific to the group. Thus, commercial law began with the rules merchant guilds wrote for each other. This tradition continues with groups involved in trading commodities such as diamonds (Bernstein). Securities exchanges write laws regarding trading and listing of shares. US exchanges have a special self-regulatory role under the securities laws, while in the UK exchange rules are themselves the main regulation of securities. These laws, as well as customs developed by particular industries (Bernstein (1996)), are designed to fit the group's norms and business practices and may be enforced via reputational sanctions.

Unlike other categories of byproduct lawmaking, industry groups are strongly motivated to internalize the costs and benefits of their rules. However, the process's limitations inhere in its strength. Internalization is possible because of the group's limited size and purpose. This type of lawmaking therefore cannot address the sort of broad problems that laws generally deal with.

Moreover, while industry groups create law *proposals*, these proposals do not obtain the critical property of laws until the government enacts or enforces them as such. Enactment brings into the picture government agents who may distort the industry group's objectives.

F. ILLUSTRATIONS OF BYPRODUCT LAWS

This subpart provides some specific examples of private lawmaking that is a byproduct of the lawmakers' other activities. These laws illustrate the central problem of byproduct legislation: the incentives that motivate this lawmaking also can divert it from first-best laws designed to maximize social welfare.

1. LLCs

As of the mid-20th century, owners' ability to limit their personal vicarious liability for their firms' debts was limited by a combination of federal corporate taxation, which effectively imposed a federal tax on limited liability, and state legislatures' unwillingness to extend limited liability beyond the controlled corporate setting (Ribstein, 2010, Chapters 4-5). Thus, many firms incurred costs in seeking their ideal business form, as described in the introduction. Private lawmaking efforts eventually spearheaded the elimination of the tax penalty on limited liability and increased state recognition of limited liability unincorporated business forms.

The creation of the LLC began a movement in state legislatures to recognize unincorporated firms in which all members had limited liability for the firm's debts. Before LLCs, U.S. states generally refused to adopt statutes that combined limited liability of all members with partnership tax treatment. The corporate tax penalty for limited liability restricted the demand for limited liability unincorporated firms, and therefore the potential payoff to state legislators from experimenting with this innovation. Indeed, prior such experiments had failed (Gazur and Goff, 393-94).

Private lawmaking efforts ultimately broke the impasse. An oil company, working though its lawyer, obtained the enactment in Wyoming of a statute authorizing a form of business it had experience with in Latin America (Carney). Lawyers acting for a private client then applied for an IRS ruling that a Wyoming LLC would be taxed as a corporation. At the same time, Georgia lawyers drafted and successfully pressed for adoption of a new limited partnership act that permitted all members of a limited partnership to have limited liability. These private lawmaking efforts forced the IRS to decide on the tax treatment of myriad types of LLCs and limited partnerships. The prospect of having to rule on numerous state statutory innovations likely helped prompt the 1988 Internal Revenue Service ruling classifying a Wyoming LLC as a partnership for tax purposes.[12] This ruling unleashed a flood of LLC statutes. Rapid evolution of these statutes ultimately persuaded the IRS to eliminate tax impediments on limited liability

[12] Rev. Rul. 88-76, 1988-2 C.B. 360.

business forms and adopt a "check-the-box" rule that allowed firms to choose whether to be taxed as partnerships and corporations.[13]

The creation and evolution of the LLC illustrates how private innovations converge with public lawmaking and jurisdictional competition to produce law reforms. There was political pressure on state and federal legislators and bureaucrats to produce a standard form that would combine member limited liability with relief from the "double" corporate tax. State legislators and federal bureaucrats, for the reasons discussed in Part II, had little incentive to invest effort and political capital in developing such a vehicle. Private parties wanted a standard form with the combination of features the LLC offered but lacked the property rights sufficient to motivate an effort to craft a socially efficient mix of standard forms for this market. The work was ultimately done by business lawyers seeking clients and taxpayers in industries like oil and gas which had little need to retain earnings did have enough to gain to justify the effort of producing the earliest LLC statutes.

Although the resulting new LLC standard form likely improved public welfare by reducing firms' mismatch costs, those who crafted the new form, particularly including lawyers, were motivated by side benefits from the new form that may have reduced its utility compared to a first-best design. In particular, lawyers gained business from firms seeking tax breaks and limited liability, and sought to accommodate those preferences. Although the LLC forms this private lawmaking produced may have been better than forms would have been in the absence of these byproduct incentives, they were likely less efficient than those that would have been produced by lawdrafters motivated only by potential profits from selling forms to private firms.

2. Expansion of LLC owners' liability protection

The creation and recognition of the LLC was only the first step in the evolution of the LLC to further extend the reach of limited liability. LLC statutes evolved to expand limited liability beyond risky enterprise to permit owners' avoidance of responsibility for their personal non-business debts. This gave lawyers a lucrative new product to sell to clients. Specifically, lawyers were influential in promoting the modification of LLC statutes to permit formation of firms with non-business objectives while enabling those firms to take advantage of a partnership rule designed for businesses that blocks members' creditors from reach firm assets (Ribstein 2005). LLCs accordingly could be used as personal asset-protection vehicles. This development may explain the large number of very small LLCs in the leading asset protection jurisdictions of Nevada and Florida (Kobayashi & Ribstein 2010).

Another example of expanded liability protection is the limited liability partnership (LLP). Lawyers invented the LLP in Texas in 1991 primarily to help them avoid the unprecedented tort and regulatory liability arising out of savings and loan cases (Hamilton, 1068-

[13] See Treas. Reg. § 301.7701-1-3 (2004).

74). Virtually all other U.S. states had adopted these statutes only seven years later (Bromberg & Ribstein 2011). The only difference between a traditional general partnership and an LLP is that the latter has limited liability. Given the dominance of the LLC, which is specially designed as a limited liability vehicle, the main use of LLPs has been to enable professional firms, particularly including law firms, to avoid state law restrictions on non-partnership professional firms (Bromberg & Ribstein 2011, §7.04). The private interests of the drafters of the new form again affected the nature of the legal innovation they produced.

3. Tax reduction vehicles

Recent statutory moves relating to business associations and other types of legal forms are best explained as efforts by private lawmakers to coordinate or focus lobbying efforts by creating specific structures under state law that would then be the basis of a federal tax break. These examples of private lawmaking efforts thus can be viewed as a byproduct of lobbying for tax laws.

One example of a tax reduction vehicle is estate freeze provisions in state unincorporated business statutes. Business owners often seek to pass their firms onto their children. However, large estate and gift taxes on the transfer could force the children to liquidate the business and thereby defeat the business owner's goal. A potential way to minimize taxes is for family-owned firms to form a limited partnership or LLC and make the owner's potential heirs limited partners or non-managing LLC members. After the founder's death the surviving members would take control of the firm. The problem is that any shares or increased value that the children receive as a result of the founder's death might be taxable. One way to avoid this result could be to make the shares non-transferable, which theoretically would sharply reduce their market value. But tax law provides that a limitation on liquidity does not count for tax valuation purposes unless it is legally, and not merely contractually, imposed.[14]

Legal innovation again intervened. A bar drafting committee in Georgia had made that state's limited partnership statute the country's first to eliminate limited partners' automatic buyout rights.[15] Lawyers alert to the tax rule discussed above spearheaded the adoption of similar estate-freeze provisions in other limited partnership statutes (Bromberg & Ribstein, §17.13(a)-(c)). The lawyers, in turn, may have hoped to capitalize on the estate planning fees these provisions would encourage. Most LLC statutes also now provide either that LLC members have no default right to dissociate or no right to be paid for their interests when they dissociate (Ribstein & Keatinge, app. 11-2).

The estate freeze provisions thus were a byproduct of lawyers' effort to maximize the use of limited partnership and LLC statutes as estate tax avoidance devices. Other, possibly more

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[14] *See* IRC (26 U.S.C.) § 2704; Treas. Reg. (26 C.F.R.) § 25.2704-2.

[15] [cite]

efficient, approaches to designing the partnership and LLCs in light of tax law might trade off the tax advantages to some firms of a freeze against the disadvantages of potentially locking owners into closely held firms, including a separate statutory form specifically designed for family firms. Lawyers had less interest in "selling" these alternative laws because they not only did not attract additional business but could reduce lawyers' fees from crafting customized contracts. On the other hand, these laws might be produced by purely private lawmakers seeking to sell their laws rather than to use the laws to pursue tax or other objectives.

Another example of a tax reduction vehicle is conservation easement statutes. Under an Internal Revenue Code provision first adopted in 1976 (§170(h)) a property owner can deduct the charitable contribution of a "qualified conservation contribution." Although tax law motivated the creation of conservation easements, state law had to make available the underlying legal structure. State statutes were jump-started by the Uniform Conservation Easement Act (UCEA), which the National Conference of Commissioners on Uniform State Laws (NCCUSL) promulgated in 1981.

The UCEA can be viewed as a byproduct of conservation easement proponents' efforts to increase the effect of a federal tax provision. Without defined state property rights, property owners would have had no reliable way of taking advantage of the favorable tax treatment. The UCEA effectively provided a "blueprint for the legislatures of the various states" (Squires (71-72)). NCCUSL was able to bring to bear expertise that was unavailable to many individual legislatures, and to develop consensus about this novel property right. This helped overcome state legislatures' reluctance to pioneer new property rights with uncertain consequences. The UCEA is also a byproduct of NCCUSL's interests in promoting uniform laws. As with other uniform laws, UCEA was designed in light of its uniformity objective.

UCEA may differ from the conservation easement law that would have resulted from a more open state competition not influenced by tax or uniformity objectives. Such a law might have better balanced tax considerations against those relating to other interests of property owners who seek, among other things, to protect their property from development (Ribstein, 2010a).

4. L3Cs

Several states, led by Vermont,[16] have enacted statutes that provide for a type of LLC, the "low profit limited liability company" (L3C) (Ribstein & Keatinge, §4:10). These statutes provide that such a firm must not have a "significant purpose" of producing income or property appreciation, and provides for name, prospectus disclosure or other special requirements clarifying this purpose. These statutes might be placed in the prior category of tax reduction

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[16] See Vt. Code, title 11, ch. 21, §3001(27).

vehicles. However, they are worth separate discussion because they illustrate more general principles of "byproduct" legislation.

In general, the main purpose of the L3C seems to be facilitate investments by private foundations that are seeking exemptions as non-profits under Section 501(c)(3) of the Internal Revenue Code. The foundations may be subject to a variety of excise taxes as a result of investments that jeopardize their charitable purposes. Congress enacted provisions in the Tax Reform Act of 1969 for a class of "program related investments" (PRI) that would not jeopardize foundations' exempt purposes and therefore would avoid excise taxes that otherwise would be imposed on the foundation's business holdings or as a result of their not making minimum distributions (Callison & Vestal, 276-79).

The L3C began as a result of the presentation by foundation head Robert Lang at the Aspen Institute's 2006 meeting, and followup by two participants to develop the idea (Schmidt, 165, n.9). Only a tiny fraction of foundations were using PRIs 40 years after the birth of the concept (Callison & Vestal, 273, n. 4). The L3C's promoters believed that use could be increased by the creation of entities in which to invest the funds that signal compliance with the PRI requirements. Accordingly, the L3C, like the estate freeze and conservation easement, is essentially a mechanism designed to promote a federal tax break.

The L3C's proponents could argue credibly that this new business form illustrates the social value of private lawmaking in promoting legal innovation. The PRI is inherently a difficult concept to apply since it attempts to graft non-profit-type restrictions onto for-profit businesses. Many firms will not fit squarely into either the for-profit or non-profit categories. Entrepreneurs may want to do good works and believe that profits are a way to accomplish this but also want something other than financial gain. For example, they may want to make investments in projects that are socially valuable but too risky to be considered positive net present value. At the same time, there is a potential problem with enabling profit-maximizing firms to compete on an uneven tax playing field. Thus, for example, it may be appropriate to give a tax head start to certain very risky firms or projects, but very difficult to define the projects for which such a tax head start is appropriate.

The L3C arguably facilitates this type of innovation in two ways. First, it tries to mitigate the uncertainty that has hobbled the PRI by providing a state statutory safe harbor that enables the federal tax exemption, analogous to the conservation easement and estate freeze provisions discussed above. Second, the L3C provides default rules that, even apart from the PRI rules, address the difficulty of contracting for hybrid profit/non-profit entities. This particularly includes defining the fiduciary duties of managers who are in the difficult position of serving both society and markets (Tyler). Although existing business associations give some leeway to managers of basically for-profit firms to mingle profits and social responsibility and permit contracting to alter the mix of these objectives (Ribstein 2006), the L3C adds clear structural

rules for defining the duties in such hybrid firms. These rules also help signal the firm's objectives to investors and customers (Schmidt).

L3Cs also can be seen as a way to avoid the effects of lawyer domination of both public and "byproduct" private lawmaking. PRIs arguably illustrate lawyer-driven complexity that attempts to achieve precise accuracy in characterizing firms at the expense of cost-effective simplicity (Hadfield). The L3C would enable firms to start up quickly without going through the costly process of IRS approval that normally accompanies the formation of a 501(c)(3) firm. A survey of the first group of entrepreneurs using the L3C showed that costs and simplicity were critical to their choice of form (Schmidt).

The L3C ultimately failed in important ways to achieve its main objective of simplifying use of PRIs when neither Congress nor the IRS endorsed use of this device. A mere state law form could not protect foundations from having to clear their PRIs with the IRS. In other words, the tax objective of the L3C failed to become "law" in the sense we use this term. The L3C therefore arguably misleads its investors with the false hope of simplicity (Callison & Vestal; Kleinberger; Kleinberger & Callison). It is not clear whether the non-PRI-driven benefits of L3Cs outweigh this potential misrepresentation risk.

L3C proponents might respond that, even if this is a problem in the short run, L3Cs still increase social welfare by providing a mechanism for clarifying the tax rule -- that is, a readymade business association that the PRI definition can refer to. Indeed, such legislation has been introduced in Congress but not yet acted on. However, it is unlikely that legislation will be passed that simply authorizes the states to decide on the scope of a federal tax exemption given the inherent conflict between states' interests in attracting business and the federal government's interest in preserving tax revenues. This is why, for example, federal tax law serves as the last word on conservation easements (Ribstein, 2010a).

Our point is not that the L3C lacks social value, but rather that a purely private lawmaker might craft a better product without the incursion of mixed "byproduct" incentives. A law drafter whose main incentive was to market her intellectual property rather than to lobby for a tax break might design the L3C to provide a suitable standard form for hybrid for/non-profit firms and leave the tax rule to the IRS and Congress. Designing the L3C primarily as a mechanism to spur Congress into clarifying the law on PRIs has resulted in a standard form that actually increases transaction costs by both skewing the terms of the standard form and misleading its users.

This analysis of L3Cs suggests that there may be limited advantages from private lawmaking in areas that are heavily influenced by regulatory or tax law. Apart from their motivation, drafters face intractable problems attempting to craft laws that they lack power to effectuate. If the private law is not a byproduct of efforts to change the regulation, it necessarily will have only limited value even if the drafters can maintain property rights in one of the ways

discussed in the next Part. The next Part shows how purely private lawmaking can be effective in situations where tax and regulatory incentives do not play critical roles.

IV. LAW AS A PRODUCT

So far we have seen that there are significant problems with the two main models of law production -- public and private/byproduct. This Part begins by articulating the impediments to private production of law and then shows how these problems might be reduced by mechanisms that encourage more direct private investment in law-creation. These mechanisms themselves involve the promulgation of "law" that would make enforcement of the resulting property rights sufficiently certain that parties could rely on them.

A. RESTRICTIONS ON PRIVATE PROPERTY RIGHTS

As indicated in the model described in Part I and as elaborated below, the creation of private property rights in law involves two significant problems. First, the government's adoption of a privately created product as law entails permitting public access to the law which reduces the property rights necessary to motivate creation of the product. More specifically, Section 105 of the Copyright Act precludes protection for any work “prepared by an officer or employee of the United States Government as part of that person’s official duties."[17] This definition extends to court opinions written by federal judges, Congressional bills and statutes, and federal regulations. State laws are subject to similar rules (Kobayashi & Ribstein (2011)). The definition does not explicitly extend to privately produced works, such as the industry codes discussed in Part III. However, courts have refused to extend copyright protection to privately produced codes that were subsequently adopted as law.[18] Also, courts have held that litigation documents in public courts cannot be secured from public access by a confidentiality agreement and protective order without a compelling justification for privacy.[19]

Second, any approach to private lawmaking that minimizes the government's involvement also foregoes significant coordination and coercion benefits that only government can confer. In other words, as discussed throughout this paper, a private law proposal lacks the critical characteristic of "law." Thus, the basic problem of encouraging private lawmaking is to find some way to steer between the horns of the dilemma of being either too much or not enough like law.

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[17] 17 U.S.C. Section 101, 105.

[18] *See supra* n. 2.

[19] *See* Brown v. Advantage Eng'g, Inc., 960 F.2d 1013, 1014 (11th Cir. 1992) (vacating district court’s order sealing court record, including pleadings and motions); Wilson v. Am. Motors Corp., 759 F.2d 1568 (11th Cir. 1985) (same); Texas Supreme Court Rule 76a (creating a presumption that court records, including unfiled discovery materials and settlement agreements, are open to the public).

B. UNBUNDLING LAWMAKING AND ENFORCEMENT

The main reason for refusing to restrict public access to privately created materials adopted as law is that these restrictions could raise due process problems as people who are subject to the laws are unable to use legal materials to defend against the imposition of penalties for violations. One possible resolution of this dilemma might be to unbundle lawmaking and enforcement, as has been suggested for Europe (Painter, Kaal and Kirchner). States might offer open-ended statutes that enforce agreements of specified types, such as a "contractual entity" (Ribstein (1999)). Private lawmakers could then sell standard forms that parties might use under this type of statute. The open-ended statute would give rise to a kind of "aftermarket" for standard forms.

The problem with this approach is that the aftermarket forms would not themselves be "law" in the sense that they are certain to be enforced. Rather, the certainty would arise only after a court decision applies the open-ended statute to authorize enforcement of the standard form. This court decision would then become law and potentially subject the private form to the restrictions on intellectual property rights discussed above. The private law-drafter's dilemma therefore remains.

C. PRIVATIZING ENFORCEMENT

Since the dilemma involving property rights in "law" arises from enforcement, a second possible path to increasing legal innovation is privatizing enforcement as well as lawmaking. In a purely private contractual regime there would be little general problem with enforcing restrictions on access to the same extent as other contracts.

The problem with this approach is that the regime would have to find suitable substitutes for law's coordination and coercion features. It is likely that that the regime would work only in a closed system like the world of the diamond merchants in Bernstein's study where notice is no problem and the parties are subject to strong reputational constraints.

D. PRIVATE ADJUDICATION PLUS PUBLIC ENFORCEMENT

A third potential approach to privatizing lawmaking is combining private adjudication with public enforcement. Current law offers a glimpse of this possibility. Parties to a pre-dispute arbitration clause can agree on procedures, including confidentiality, and can count on having the arbitrator's award enforced under state law and the Federal Arbitration Act. Delaware now competes with arbitration by allowing parties to agree, for a fee, to have their case governed by expedited and confidential arbitration before a Delaware judge with direct appeal to the

Delaware Supreme Court. This mechanism merges features of both public adjudication and private arbitration.[20]

The key feature missing from private adjudication is publicly available judicial-type opinions. The parties to an arbitration proceeding could agree to pay the arbitrator to produce a written opinion. However, confidentiality may be valuable to the parties to the case, as where it preserves proprietary business information or protects against release of embarrassing material. Also, any benefit from the opinion in terms of increased predictability of result would accrue to litigants in subsequent cases. It follows that parties will agree to such a system only if they benefit over time from having their transactions subject to clear legal rules. The state is in the best position to provide and guard the integrity of such a durable system. But if the state does provide such law, it arguably needs to ensure that the public has general access to the proceedings. This returns to the basic problem of protecting property rights in private lawmaking. The dilemma of private lawmaking remains.

E. PERMITTING PRIVATE PROPERTY RIGHTS IN LAW

The above analysis demonstrates that the best way to enable more robust private lawmaking is by reversing the legal restrictions on property rights in law discussed in subpart A. More specifically, Congress could legislatively qualify Section 105 of the Copyright Act to limit its application to private materials that have the effect of law. This could involve giving private lawmakers some property rights in law short of the full-fledged control inherent in a private property regime. For example, the parties to a case or their lawyers could retain property rights in litigation materials, including pleadings and any judicial type opinion, but be required to license the materials for public use subject to an access fee. With respect to a privately produced statute, the courts could allow the lawdrafter to license a jurisdiction to use the statute for a fee while allowing those bound by the code to access it for free.[21] As long as the system results in a public benefit of additional, more innovative, law, the public should be willing to pay the cost.

This rule would enable a private lawdrafter to create intellectual property knowing (1) that it has some positive chance of acquiring the valuable properties of "law"; and (2) that if the property is adopted as "law" the intellectual property rights would continue to be enforced. For example, the creator of a model building code could post code on a website with a licensing agreement secure in the knowledge that it will retain its property rights even if a municipality adopts the code. In this way, lawdrafters could avoid the Hobson's choice under current law between non-law and no property rights in law.

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[20] *See* Delaware Chancery Court Rules 96-98 (February 1, 2010), http://www.delawarelitigation.com/uploads/file/int23.PDF.

[21] This is a potential solution for a case like *Veeck,* cited in note 1 above, in which adopting municipalities violated the plaintiff's licensing agreement posted on his website with the code.

V. CONCLUDING REMARKS

Legal innovation is important, but may be underproduced because of public lawmakers' weak incentives. Private lawmaking is a potential solution to this problem. However, under current law this lawmaking faces the horns of a dilemma: it requires government enforcement and recognition, yet such enforcement and recognition necessarily reduces the property rights that are essential to motivate private lawmakers. We have shown that the best approach may be to find a better balance between public access and private rights.

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