LAW AS A BYPRODUCT: THEORIES OF PRIVATE LAW PRODUCTION

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ABSTRACT

Public lawmakers lack incentives to engage in a socially optimal amount of 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. Because of this dilemma, 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.

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Lawmaking generally has been considered the province of government agents subject to political control. At the same time, 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. Also, public lawmakers have weak incentives to produce socially valuable legal innovations, in part because they share little of the public benefits of producing laws (Hadfield & Talley (HT)). But given the need for government ordering, there seems to be little alternative to incurring these political costs.

Private lawmaking may, however, be a feasible alternative to government lawmaking for some types of laws. Although the government is often in the best position to reconcile the positions of competing interest groups regarding public law, private lawmaking may be well-suited to structuring relationships among economic actors. This can include statutory business structures that are well-adapted to regulation or tax laws that necessarily are produced by government. HT show that private lawmakers may have stronger incentives to produce efficient law of this type than do public lawmakers.

Private lawmaking is potentially an important source of innovation. Legal 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.

This paper's main contribution is showing that private parties' ability to supplement public lawmaking depends on whether they have robust intellectual property rights in law. We distinguish private law*drafters,* who produce legal materials that may or may not become law, from public law*makers,* who are empowered to adopt their products as law. The basic conundrum that we identify is that private lawdrafters cannot simultaneously have property rights in their creations *and* have these creations adopted as laws. 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,

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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.

parties and firms may find it cheaper to pull a standard form off the shelf and adapt it for a specific use. The purely private standard forms in which private lawdrafters have property rights, however, lack the valuable characteristics of *laws*.

The conundrum of private property rights in law requires a definition of "law." We define this term to include provisions the state very likely to enforce because they are promulgated or approved by government (Snyder). Parties' 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 with many parties who may be affected by the actor's conduct (Coase). Certainty of enforcement also helps make law an effective coordinating device (Hadfield and Weingast) and a focal point for the development of a large body of cases (Ribstein (1995)).

Law, however, is a two-edged sword. While government's involvement gives law its essential characteristic of certainty of enforcement, it also requires relaxing private property rights in law to give people full knowledge of the law and the ability to defend themselves in actions charging violations. Thus, it has been held that once a legislature or court makes privately produced materials into law its author loses any intellectual property rights she might have had.[2] Legal innovators accordingly must accept the risk their property rights will be limited if they achieve their goal of creating law. Private lawdrafters therefore face a Hobson's choice between weak rights in the valuable property of law and stronger rights in the less valuable property of non-law.

As a result of limitations on private lawmaking, private parties' involvement in lawmaking occurs mostly as a byproduct of political rent-seeking and other activities rather than in pursuit of sales in a commercial-type market. 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.

The problem with legal innovation resulting from this byproduct process is that it 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 some of the situations in which there is a demand for legal innovation. Moreover, innovation may come at

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[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). The precise scope of the public's guaranteed access and commensurately of authors' property rights in law are discussed below in Part IV.C.

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 political lobbying and other activities. Part IV discusses changes in the legal infrastructure regarding property rights in law 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 or market structures. 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. The following situation will assist visualizing the model. Assume the situation that actually existed at as the middle of the twentieth century in the U.S. of only a single type of statute suited for closely held firms, specifically the Uniform Partnership Act as adopted by all states. Under this statute the parties have broad freedom to structure their relationship as they wish except that the firm's owners must assume vicarious liability for the firm's debts. Although the parties could set up a limited partnership in which passive investors have limited liability, one who exercises the power of a

general partner in such a firm necessarily takes on vicarious liability. Most states did not provide for a flexible form of business that allows managing owners of small firms to avoid vicarious liability for the firm's debts. Parties' demand for such a form, and therefore states' incentive to provide it, was limited by the fact that under U.S. tax law the members' limited liability would deprive them of the desirable tax characteristic of "single-level" partnership taxation. We consider the circumstances in which private lawmakers might fill this gap in statutory standard forms.

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] Firm j's structure x_j represents the firm's optimal organizational structure, which includes members' participation in management plus limited liability and partnership tax treatment. 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 parties can, of course, attempt to contract for their desired characteristics. However, this contract would present a variety of problems related to enforcement. First, a court may not enforce the parties' contractual expectation of limited liability against a third party who neither expressly nor impliedly agreed to the liability limitation. Second, the tax consequences of the parties' contract depend on tax law rather than the parties' agreement. Third, the terms of the contract among the parties may not be clear because neither a statute nor any judicial decision specifies how courts should fill the inevitable gaps that arise because of the unpredictability of future events over a long-term relationship. For example, one party may attempt to seize benefits from the relationship that the contract neither expressly forbids nor clearly permits. Although the situation might be appropriate for application of partnership-type fiduciary duties, it may not be clear whether or how a court will apply such duties to a relationship in which the parties all have limited liability.

An alternative approach is for private lawdrafters to promulgate a standard form (say, a limited liability company or LLC) for a relationship that provides the desired characteristics of limited liability, partnership taxation and management flexibility. The question then is precisely what difference it makes to contracting parties whether government lawmakers adopt this standard form 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 statutes adopted as law by a

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

legislature are enforced with probability $\phi = 1$ and that privately produced provisions not so adopted have a probability of enforcement $\phi \leq 1$.[4]

An additional question arises for firm j whose optimal structure x_j does not perfectly match those provided for in the statute. For example, j may want to have limited liability for some but not all of its members. This may raise questions such as whether the liability limitation is enforced for members who want it and not for members who do not, the effect of the liability rule on the parties' fiduciary duties, and the tax consequences of partial limited liability. The firm can eliminate this uncertainty by forming under the new statute, but incur mismatch costs because the statute does not give the firm its most preferred set of rights. Alternatively, the firm can enter into its contract but have uncertainty as to the extent to which its preferred rights will be enforced.

With this example in mind, assume the costs of organizing firm j under provisions of a public statue with characteristics $s_i, \in [0,1]$ are:

(1) $C_j^{PUBST} = \tau \cdot (s_i - x_j)^2$.

The transaction cost τ represents the costs to each firm located at x_j of operating under or contracting around default provisions (s_i) that do not perfectly fit the parties' needs. Like HT, we adopt a quadratic mismatch cost function, so these costs rise at an increasing rate as the firm's ideal point x_j moves away from provisions included in s_i.

If there is no statute at $s_i \in [0,1]$, we assume the firm can operate under an existing statute E (i.e., the UPA in our example) located outside this interval. Mismatch costs equal $M\tau$, where $M > 1$. The value of the statute to firm j is the firm's reduced costs of organizing and operating under the statute located at s_i. In other words, the marginal value of adopting s_i instead of s_E is given by:

(2) $K_j^{PUBST} = \tau[M - (s_i - x_j)^2]$.[5]

If $M > 1$, $K_j^{PUBST} > 0$, all firms with ideal points $x_j \in [0,1]$ will strictly prefer to organize and operate under a new (i.e., LLC) statute at $s_i \in [0,1]$ to forming under an existing (i.e., UPA) statute E at $s_E \notin [0,1]$. The new statute accordingly may be a type of innovation that increases social wealth by reducing transaction costs.

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[4] The assumption that public statutes have a probability of enforcement equal to one is not necessary to our results. All that is needed is that the probability of enforcement for a public statute is higher than the probability of enforcement for a privately produced set of provisions not adopted as law.

[5] HT do not explicitly derive the individual firms' demand for a statute K, and assume that K is large so that the net benefits of adopting a statute at a_i are positive.

Privately produced provisions can impose not only the mismatch costs identified above, which are incurred with probability ϕ, but also reorganization cost R when government does not enforce the provisions the firm adopts. The firm then incurs higher costs equal to $R\tau$, where $R > M > 1$. These higher costs, which occur with probability $1 - \phi$, can include disruption of business plans, legal fees, penalties and liabilities. 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:

(3) $C_j^{PRV} = \phi\tau(a_i - x_j)^2 + (1 - \phi)R\tau.$

The marginal value of adopting a_i instead of s_E is given by:

(4) $K_j^{PRV} = \tau[M - \phi(a_i - x_j)^2 - (1 - \phi)R].$

It follows that, unlike adding a *statute* at $s_i \in [0,1]$, firms will not strictly prefer a private provision at $a_i \in [0,1]$ to operating and organizing under the existing statute at s_E because of the risk of non-enforcement. As discussed below in subpart D, there is a critical enforcement probability below which firms will prefer statute s_E over private provision a_i.[6]

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 operating under. . .

	Expected Mismatch Costs	*Expected Reorganization Costs*	*Expected Total Costs*
1. Existing statute $s_E \notin$ [0,1] ($\phi = 1$)	$M\tau, M > 1$	0	$M\tau$
2. Non- law private provisions $a_i \in [0,1]$ ($\phi \leq$ 1)	$\phi\tau(a_i - x_j)^2$	$(1 - \phi)R\tau, R > 1$	$C_j^{PRV} = \tau[\phi(a_i - x_j)^2 + (1 - \phi)R]$
3. Statute at $s_i \in [0,1]$ ($\phi = 1$) (HT cost function)	$\tau(a_i - x_j)^2$	0	$C_j^{PUBST} = \tau(a_i - x_j)^2$

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[6] We recognize that a government adopted statute may not always have a higher probability of enforcement than a privately produced provision. There may be, for example, strong reputational or other costs binding the parties to a private provision. Conversely, the parties may be uncertain about which court will apply the statute and how the court will interpret the statute as applied to particular fact situations. We leave more detailed comparisons between statutes and private law for another day. As noted above in note 4, it is enough for present purposes that the adoption of a statute increases the probability of enforcement compared to a privately produced provision that is not embodied in the statute.

To see the distinction between mismatch and reorganization costs, consider Firm j with ideal point x_j that can organize under provisions perfectly matched to its needs, so that 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.[7] Since $s_i = x_j$, the firm's total mismatch and reorganization costs then 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 ($a_i = x_j$) but will face positive expected reorganization costs ($(1-\phi)R$).
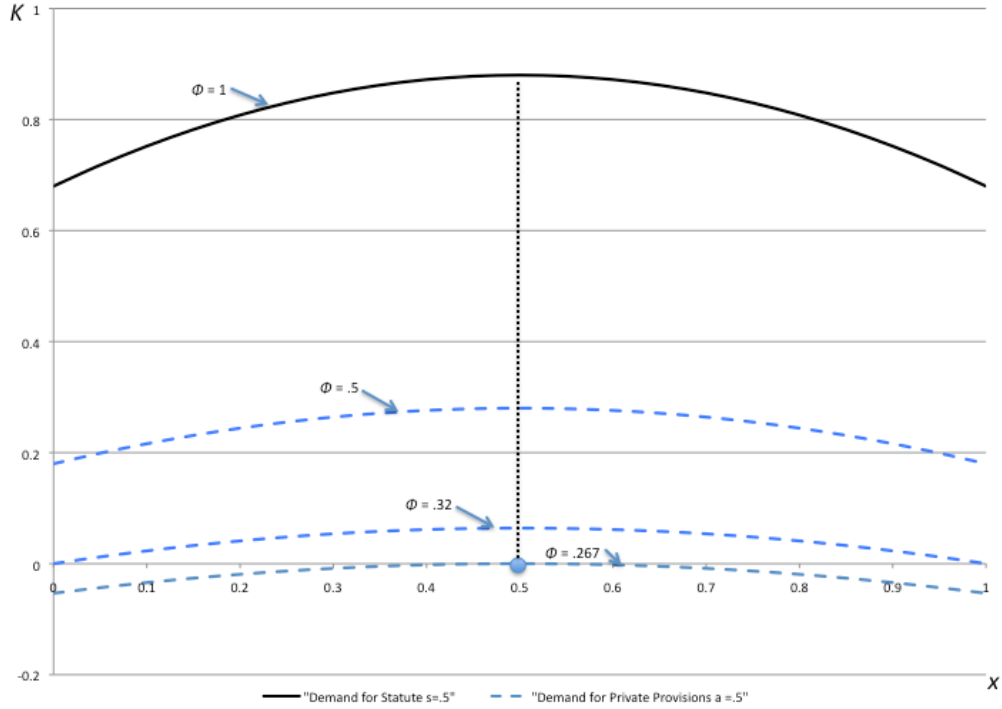

Figure 1 – K^{PUBST} versus K^{PRV}

Figure 1 shows the demand for a public statute at $s = \frac{1}{2}$ and the demand for a private set of provisions at $a = \frac{1}{2}$ when $\tau = .8$, $M = 1.1$, , *and* $R = 1$, and when $\phi = .5$, .32, and .267. In the latter case, the demand for the statute is zero or negative over the entire range of x.

Against this background consider a Firm j that wants the features of a limited liability company (LLC), including limited liability, partnership taxation and flexible 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 s_E. If Firm j operates under the existing Uniform

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[7] The assumption 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 this probability is lower than if the firm adopted identical provisions that have not been adopted as law.

Partnership Act it will incur high mismatch costs $M\tau$ because it must forgo either limited liability or partnership taxation, but it will not face 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 or operating under less suitable default provisions. For example, consider a firm with an ideal structure that includes several related firms each with liability limited to the debts contracted by the particular constituent firm. Such a "series" LLCs (described in Ribstein & Keatinge §4:17), 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 the risk of reorganization costs if 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 are in addition to the mismatch costs of forming and operating under a_i (Row 2 of Table 1). But if Firm j forms and operates in a state that has adopted an LLC statute containing provisions s_i the firm would not have to bear costs related to the uncertain enforcement of LLC terms.[8] This firm bears only mismatch costs and not expected reorganization costs (Row 3 of Table 1).

Finally, compare with the private lawmaking alternative the choice an idealized public lawmaker would make. The public lawmaker maximizes social welfare by locating N statutes along the interval [0,1] in order to minimize firms' mismatch costs and allowing firms to have free access to the statutes. The lawmaker can accomplish this by locating the statutes at even intervals [*1/2N, 3/2N, 5/2N, ... (N-1)/2N*]. Total mismatch costs with *N* statutes equals:

$$(5) \qquad C^* = N\tau \int_0^{1/N} (x - \frac{1}{2N})^2 f(x)dx$$

With a uniform distribution with range [0,1], *f(x)* = 1 and the costs of mismatch equal

$$(5') \qquad C^* = N\tau[\frac{1}{3}x^3 - \frac{1}{2N}x^2 + \frac{1}{4N^2}x]\Big|_0^{1/N} = \frac{\tau}{N^2}[\frac{1}{3} - \frac{1}{2} + \frac{1}{4}] = \frac{\tau}{12N^2}$$

For example, a government promulgating one statute would locate it at $s = \frac{1}{2}$ and total mismatch costs would equal $\tau/12$. If the government promulgates two statutes, it should locate them at $s_1 = \frac{1}{4}$, $s_2 = \frac{3}{4}$, with mismatch costs of $\tau/48$.

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[8] If the firm operates in a different jurisdiction, the statute may not be enforced as law in that jurisdiction. This would be comparable to the firm's adopting a private non-law agreement. This illustrates how the choice of law rule must be factored into whether a given provision is "law."

The optimal number of statutes N^* increases until the marginal mismatch cost savings of an additional statute is less than the cost of drafting and promulgating the statute (F). Thus, it pays to add the *Nth* statute if:

$$(6) \qquad \frac{\tau}{12(N-1)^2} - \frac{\tau}{12N^2} > F$$

or equivalently, if:

$$(6') \qquad \frac{1}{(N-1)^2} - \frac{1}{N^2} > \frac{12F}{\tau}$$

Figure 2 illustrates the social benefits from adding a second statute. Figure 1 shows firms' demand for a single statute at $s = .5$, and the demand for a pair of statues at $s_1 = \frac{1}{4}$, $s_2 = \frac{3}{4}$ when firms are distributed uniformly over the [0,1] interval, and $\tau = .8$ and $M = 1.1$. The gross marginal benefits of adding a second statute equals area A + area C – area B in Figure 2. In the example, this would equal the reduction in mismatch costs, and would equal $\tau/12 - \tau/48 = \tau/16 = .05$. Thus, two statutes located at $\frac{1}{4}$ and $\frac{3}{4}$ would be preferred to one statute at $\frac{1}{2}$ if $F < .05$.
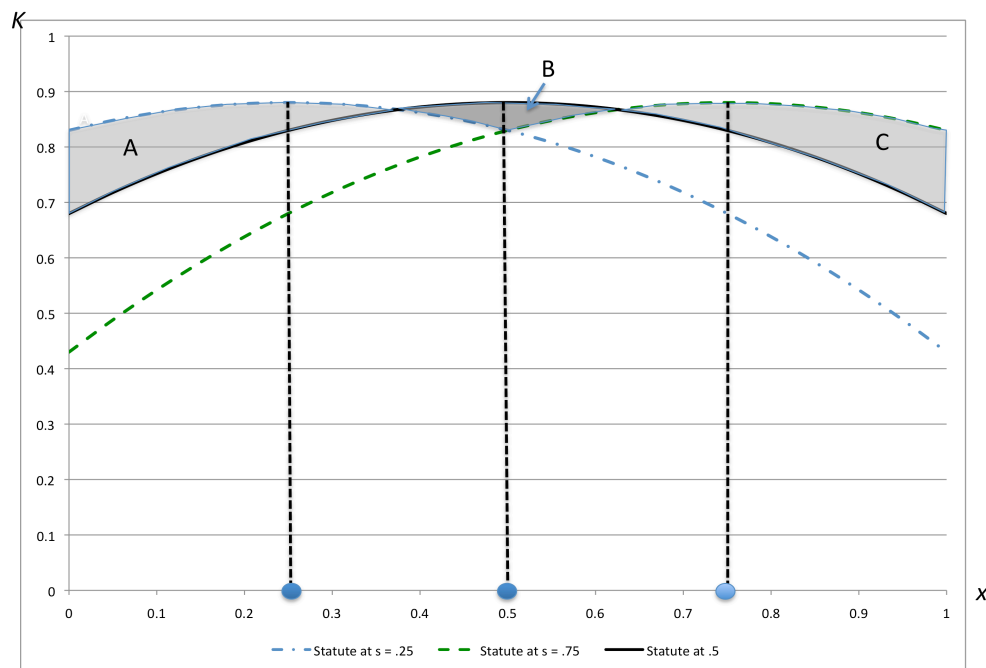

Figure 2 – Gross Social Marginal Benefits of an Additional Statute in the [0,1] Space

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

by intellectual property law. We discuss two types of intellectual property regimes. Section 1 discusses a regime which protects specific statutes produced by private lawmakers from copying by other lawmakers and firms, but allows different statutes to serve similar "locations," by which we mean types of firms. Section 2 discusses a regime which gives private lawmakers exclusive rights to all potential laws located in the entire [0,1] space. The location of the type of business association statute we are modeling might, for example, broadly include all closely held firms or more narrowly include closely held firms with centralized management and passive owners that need limit liability and flow-through taxation.

1. Specific laws

This section discusses a regime like the one HT examine in which producers of private statutes (i.e., where $\phi = 1$) get copyright-like intellectual property protection from unauthorized reproduction of their work, but not from competition by different statutes serving the same market. As discussed below in subpart IV.B, the author might be allowed to capture benefits from producing the statute by selling or licensing it to government entities. The government/licensee can charge a franchise fee to firms that form in the jurisdiction which can include a charge to cover the license fee for the statute. There would be no direct charge for use of the statute by those bound by the law. This regime would enable private lawdrafters to maximize profits by choosing both the statute's location s_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 $s_1 = 0$ and $s_2 = 1$) and price them at τ more than the marginal cost of selling the statute. Our model also can generate the same extreme differentiation as long as the statute author gets only copyright-like rights rather than a patent-like right to prevent competing providers from locating a statute near an existing location. This would resemble ideal copyright protection that protects original expression from copying, but would not protect the underlying ideas contained in 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 location of the first statute increases the number of firms that use and pay for the statute. On the other hand, this move decreases what firms are willing to pay for using the statute. Moreover, as noted above, the model assumes a non-linear relationship between firms' customized drafting costs and their distance from the nearest form. This reflects the intuition that shifts in individual contract provisions, such as liability for the firm's debts, management, control and profit-sharing in a firm's governance structure, change relationships between the characteristics and therefore necessitate redrafting of these other characteristics. Because of this non-linearity, the negative effect on price can dominate the positive effect on

quantity. Thus, private authors have an incentive to move away from each other when choosing the location of their statute.

Extreme differentiation is not a first-best result from a social welfare standpoint. Specifically, assuming firms are uniformly distributed over the [0,1] interval, total mismatch costs are equal to:

$$(7) \qquad C^{CR} = \tau \int_0^{1/2} (x)^2 dx + \tau \int_{1/2}^1 (x-1)^2 dx = \frac{\tau}{12}$$

Thus, the extreme differentiation regime yields mismatch costs equal to that of an optimally placed single statue at $s = \frac{1}{2}$, but at twice the drafting cost, or *2F*. Two optimally placed statutes at $s_1 = \frac{1}{4}$ and $s_2 = \frac{3}{4}$ yield lower mismatch costs $\tau/48$ for the same upfront drafting cost.

2. Types of laws

Owners of privately produced laws might get not only copyright-like protection from exact copies, but also stronger monopoly rights to the general space occupied by a type or category of laws. In theory, this might include patents to novel and non-obvious legal methods.[9] As we discuss in Part IV, a more direct route to monopoly rights would be for the drafter to sell or license the statute to a government entity which has monopoly rights over the space.

Consider, for example, intellectual property protection that gives the innovator property rights to the interval [0,1]. If the monopolist produces N statutes, it will locate the first statute at 1/2N from 0 and space additional statutes evenly every 1/N apart. Thus, two statutes will be located at $\frac{1}{4}$, $\frac{3}{4}$, and three statutes at 1/6, 3/6, 5/6. With equal prices, firms in the interval 1/2N on each side of the statute will demand the statue for all prices below

$$(8) \qquad p^L = \tau[M - (\frac{1}{2N})^2].$$

This is the price that makes the firm with ideal point x_j that is 1/(2N) away from a statute a_i indifferent between using this statute and incurring cost $M\tau$ using statute a_E.

To demonstrate that it is optimal for the monopolist to charge the limit price $p* = p^L$, we need to show that $\frac{\partial \pi}{\partial p} < 0$ when evaluated at p^L. If this is true, then the monopolist would not want to raise price above p^L, as profits would fall, and would not gain from lowering price because this would not enable it to sell or license additional units.

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[9] Kobayashi & Ribstein (2011) discuss patent protection of legal methods and its limitations under current law.

To demonstrate the conditions where $\frac{\partial \pi}{\partial p} < 0$, note that a lawmaker's profit will equal

$$(9) \qquad \pi = 2S(p-c)\sqrt{M - \frac{p}{\tau}}$$

where S is a variable that scales up demand, so that the aggregate demand in the interval $[0,1]$ is S. The derivative of the profit function with respect to p is given by

$$(10) \qquad \frac{\partial \pi}{\partial p} = 2S\sqrt{M - \frac{p}{\tau}} - \frac{2S}{\tau 2\sqrt{M - \frac{p}{\tau}}}(p-c).$$

At $p = p^L$, $2\sqrt{M - \frac{p^L}{\tau}} = \frac{1}{N}$, so:

$$(11) \qquad \frac{\partial \pi}{\partial p} = \frac{S}{N} - \frac{2SN}{\tau}(\tau[M - (\frac{1}{2N})^2] - c) < 0$$

when

$$(12) \qquad N^2(M - \frac{c}{\tau}) > \frac{3}{4}$$

If the above condition is not satisfied, then the optimal price will equal

$$(13) \qquad p^* = (2\tau M - c)/3 > p^L.$$

If c = 0, then the above condition will always be satisfied, as N ≥ 1, and M > 1. By continuity, the condition will hold for small c.[10]

3. Social welfare aspects of private production of statutes with property rights

Section 2 shows that, where private law producers have intellectual property protection for their products, they have an incentive to engage in socially optimal production of private statutes under widely applicable conditions. However, the conditions for optimality will not always prevail. When they do not, the private producer may produce a socially excessive number of statutes, or may charge a price for access to its statutes that is high enough to induce some buyers to choose to use the existing statute with higher mismatch costs. This suggests that

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[10] Because the statutes contain information that can be distributed at low cost given current technology, it is likely the case that c will be small and that condition (12) will hold. Indeed, relatively low distribution costs compared to the costs of producing an idea is a ubiquitous assumption in economic analyses of the production of information and innovation.

there might be a justification for regulation of pricing or creation of statutes or limits on private property rights in law.
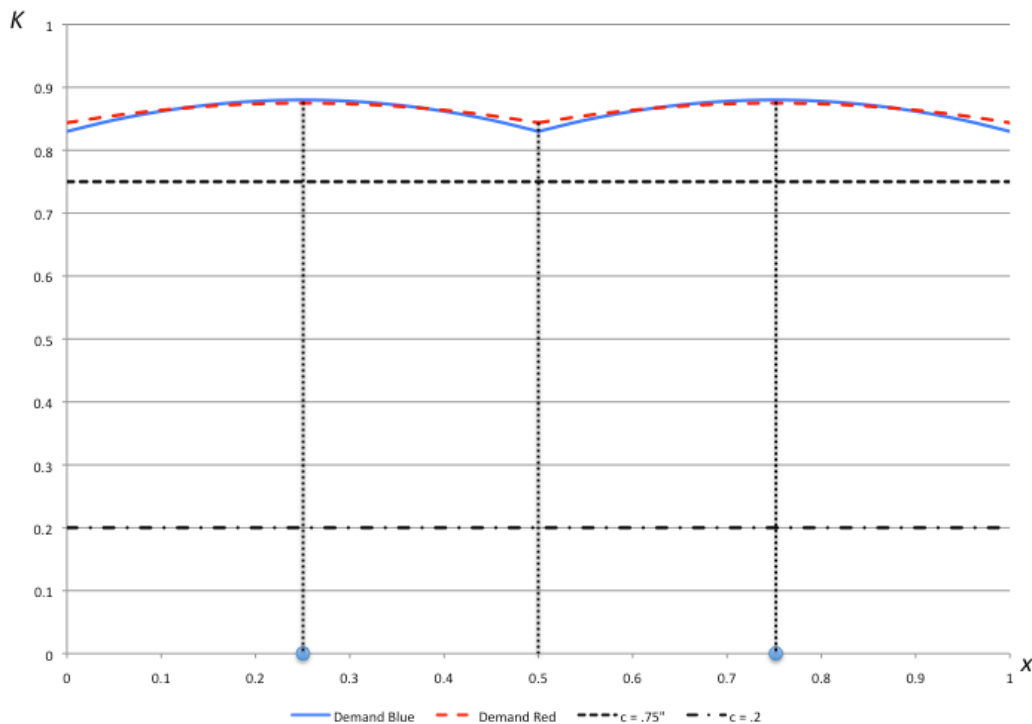

Figure 3 – The Use-Creation Tradeoff

Figure 3 illustrates the tradeoffs involved when the producer has an incentive to price some users out of the market. The figure illustrates two demands for statutes located at ½ and ¾, the "blue" demand based on parameters $\tau = .8$ and $M = 1.1$, and the "red" demand based on parameters $\tau = .5$ and $M = 1.75$. Suppose that the cost (c) of distributing a copy of the statute $= .75$.

In the "blue" case, the left hand side of condition (12) equals .65, so condition (12) is not satisfied. The optimal price $p* = .837 > p^L = .83$, so that the marginal firms with ideal points near $x = 0$, $x = .5$ *and* $x = 1$ will be optimally priced out of the market and will choose to organize under the existing statute s^E even if this statute is not as well matched to the firms' needs as the private statute.

In the "red" case, the left hand side of condition (12) equals 1. Condition (12) is satisfied, and $p* = p^L = .844$. The profits foregone for marginal firms that are priced out of the market when price is raised above p^L are larger than with the blue demand and larger than the increased profits from higher prices to the firms that continue to use the statutes in the [0,1] interval.

If costs are lower at $c = .2$, condition (12) is satisfied for both the blue and red demand (the left hand side of (12) equaling 3.4 and 5.4 respectively). Thus $p* = p^L$ in both cases. Again, lower cost increases the profits forgone when the marginal firms are priced out of the market.

In some cases private lawmakers may have an incentive to produce too many statutes. Assuming that Condition (11) is satisfied, the marginal benefit to the lawmaker from adding an additional statute will equal

$$(14) \quad \frac{\Delta \pi}{\Delta N} = S*[p^L(N-1) - p^L(N)] - F = \tau M - \frac{1}{(2(N-1))^2} - \left[\tau M - \frac{1}{(2N)^2} \right] - F$$

or equivalently

$$(15) \quad \frac{1}{(N-1)^2} - \frac{1}{N^2} > \frac{4F}{\tau}$$

Comparing (15) to equation (6') shows that the lawmaker with property rights over the interval [0,1] will have socially excessive incentives to promulgate statutes. In other words, the lawmaker will propose statutes even beyond the point where drafting costs exceed mismatch cost savings.
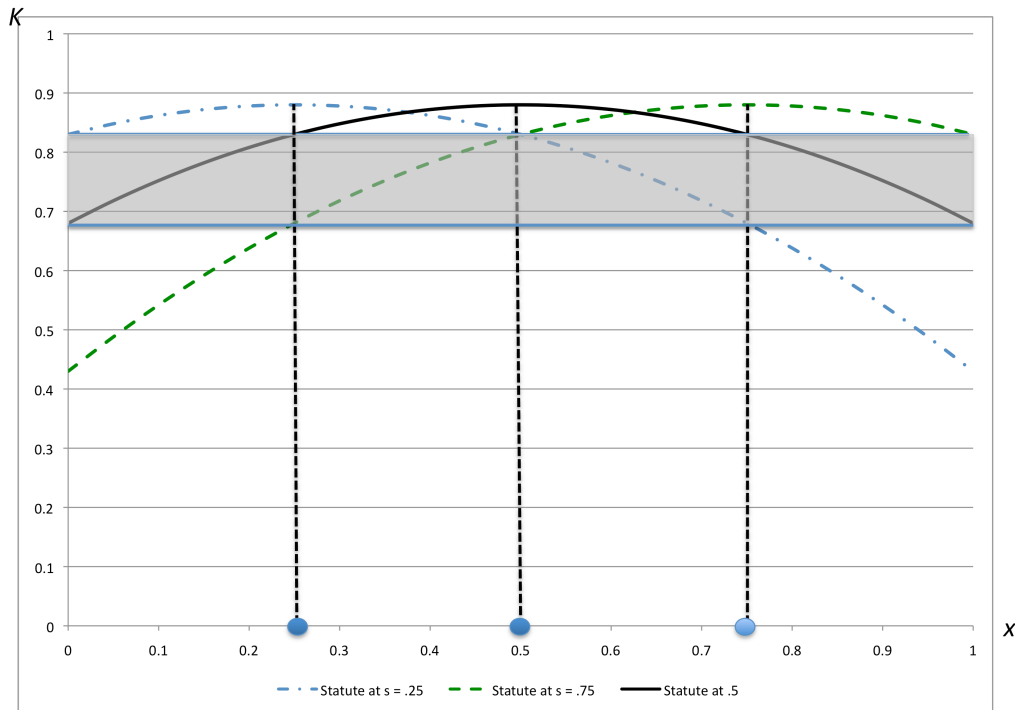

Figure 4 – Gross Private Marginal Benefits of Adding an Additional Statute in the [0,1] Space.

Figure 4 illustrates the marginal gain to the lawmaker with property rights over the interval [0,1]. In contrast to the social gains from adding a second statute illustrated in Figure 1, the gross marginal gain to the private lawmaker is determined by the effect of an additional statute on the uniform price charged to all firms. This, in turn, depends on the value of the statute to the marginal firm, p^L. Thus, the marginal gain to the private lawmaker equals the rectangular area in Figure 2 bordered above by the horizontal line at $p^L(N=2)$ and below by the horizontal line at $p^L(N=1)$. Because this effect is larger than the social benefit for infra-marginal firms, the lawdrafter's private benefit from an additional statue will be greater than the social value of an additional statute.

The above analysis of social welfare aspects of private law production focuses solely on drafting and mismatch costs. This excludes several potentially important factors that may determine the production of private law. First, the focus on mismatch costs leaves out of the analysis transaction costs resulting from imperfectly articulated legal rules that may result from the over-production of legal forms. This consideration may underlie the "numerus clauses" principle which limits the menu of property ownership forms from which parties can choose (Merrill & Smith). It is worth noting, however, that in the context of business association and other contractual standard forms, parties' ability to choose the applicable form and state law and therefore take into account potential confusion costs likely minimize 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).

Second, the above analysis does not consider factors other than mismatch costs that might determine parties' choice of firm, particularly including network effects. Firms' costs of using a particular form may depend on the extent and quality of the "network" of legal materials available for interpreting and applying the form (Klausner). This network may determine both firms' mismatch costs and the degree of legal certainty (ϕ) regarding a particular term.[11] It follows that the availability of a set of statutes in a particular space may depend on the order in which these statutes are produced over time and not just on the statutes' and firms' intrinsic characteristics. Network effects may prevent entry of private forms even if these forms would reduce total mismatch and drafting costs in the absence of such effects. Network effects do not necessarily prevent the emergence of a more efficient form (Kobayashi & Ribstein, 2001). However, we cannot eliminate the possibility that this might occur. This has implications for several issues discussed below. In particular, byproduct or public laws may dominate private laws notwithstanding the latter's theoretical potential for increasing social welfare in the absence of network effects.

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[11] In other words, the "law," which this paper associates with certainty, includes not only statutory provisions but also common law rules interpreting the statutes. The value of all these legal rules, in turn, depends on associated materials assisting in understanding these legal rules.

Although these complicating factors may be relevant in determining the optimal types and number of private and public laws, they complement rather than undermine our analysis. Our model suggests that mismatch costs may be significant and that total mismatch costs depend on the incentives for producing private law. This insight remains useful even if creating such incentives does not eliminate the need for additional regulation of law production.

C. PRIVATE INCENTIVES WITHOUT INTELLECTUAL PROPERTY FOR LAW

The model of a market for privately produced law protected by intellectual property illustrates 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. This subpart considers the implications of incorporating reasonable assumptions about intellectual property rights in law into the model. Subpart IV.B. discusses these rights in more detail.

First, HT assume that privately drafted provisions are equivalent to public statutes in the sense that both are law and certainly enforced ($\phi = 1$). The total costs of HT private laws therefore equal the quadratic mismatch costs listed in Row 3 of Table 1 and do not include reorganization cost R. However, this is inconsistent with our assumption that only government agents can adopt "laws" in the sense of provisions that are enforced with certainty.

Second, HT assume that private authors are price setters who can appropriate the returns from their work. However, as noted above,[12] this assumption does not hold under current law because copyright law does not protect privately produced models that are adopted as law, and patent law is unlikely to apply to many legal ideas.

Given their weak copyright protection in law, private drafters of provisions that are adopted as law face free riding by potential users of their work and by competing jurisdictions. Buyers therefore will have a highly elastic demand for their product such that even a slight increase in price will sharply reduce demand as the market moves to cheaper copies. Private lawmakers accordingly will be unable to set prices as HT assume. More precisely, any demand for a copy of a privately produced statute would be based solely on differences between potential users' costs of access to the statute (δ), which likely would be the same for all 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 the effect of reducing the number of firms adopting the statute. If lawmakers are price-takers facing perfectly elastic demand curves, they have no

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

incentive to try to differentiate their products in order to better fit market needs. If there are only two statutes, 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 lawmaker (that is, a drafter of a statute at s_i where $\phi = 1$) who 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 customers and copycat producers to free-ride on drafting firms' investments and to sell or use the same products without having to incur drafting costs or compensate the statute's author. Given $s_1 < s_2$ (that is, s_1 is closer to 0 in the ideal point space x), the first private lawmaker's choice of location s_1 will result in firms with ideal points between 0 and x^c choosing to organize under s_1.[13] The demand (x^c) for s_1 is

(16) $x^c \equiv (s_1 + s_2)/2 + (p_2 - p_1)/(2\tau(s_2 - s_1))$.

Private lawmaker 1's profits are

(17-1) $\Pi_1 = (p_1 - c)x^c - D = (p_1 - c)[(s_1 + s_2)/2 + (p_2 - p_1)/(2\tau(s_2 - s_1))] - D$

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 $1 - x^c$, and its profits are:

(17-2) $\Pi_2 = (p_2 - c)(1 - x^c) - D = (p_2 - c)[1 - (s_1 + s_2)/2 - (p_2 - p_1)/(2\tau(s_2 - s_1))] - D$

A price-taking private lawmaker will choose statute location s_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 $p_2 = p_1 = \delta$:

(18-1) $\partial\Pi_1/\partial s_1 = (p_1 - c)[1/2 + (p_2 - p_1)/(2\tau(s_2 - s_1)^2)] = (\delta - c)/2 > 0$.

(18-2) $\partial\Pi_2/\partial s_2 = (p_2 - c)[-1/2 - (p_2 - p_1)/(2\tau(s_2 - s_1)^2)] = -(\delta - c)/2 < 0$.

It is important to emphasize 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 s_1 while profits for private lawmaking firm 2 are decreasing in s_2, with the result that both private lawmaking firms would locate at a single point such that $s_1 = s_2 = \frac{1}{2}$. In other words, if private lawmakers face a perfectly elastic demand curve and cannot set price,

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[13] More precisely, expected demand for private lawmaker 1's model equals $F(x^c)$, the distribution function of firms evaluated at x^c. With a uniform distribution, $F(x^c) = x^c$.

their incentive to differentiate will be as weak as that of HT public lawmakers. However, competition over location will lead them, in the case of N = 2, to locate at the center of the [0,1] interval.

For private lawmakers who 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 competing providers as well as users 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 s_E.

The discussion so far in this subpart assumes that formal intellectual property rights are the only way to the only way to provide adequate incentives to private lawdrafters. In addition to formal property rights, lawdrafters may have informal contractual mechanisms for protecting intellectual property rights to certain types of legal information products. For example, the forms may be protected as trade secrets secured by non-competition and confidentiality agreements. However, as discussed in Kobayashi & Ribstein (2011), enforcement of these rights may be limited by policy concerns about lawyer independence and public access to law. Moreover, trade secret protection ends upon disclosure, which generally is necessary to interpret and apply the form. A more potent informal protection of private forms is through first mover advantages from proposing private standard forms that firms adopt even before the forms are embodied in a statute. Numerous cases and other legal analyses interpreting the form may create network effects that give the form some of the advantages of law. For present purposes it is unnecessary to evaluate the precise effect of these informal protections as long as formal intellectual property rights can provide additional protection in some situations, and therefore encourage the production of some forms that would not be produced in the absence of this protection.

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 possibility that the private model law's terms will not be enforced raises the expected cost of using the model law and thus reduces what 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 always prefer a privately or publicly produced statute (where $\phi = 1$) at $s_i \in [0,1]$ to organizing and operating under an existing statute at a_E because

mismatch costs are smaller and the expected reorganization costs $(1 - \phi)R\tau$ 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 s_E) is negative when the expected costs of reorganization exceed the expected reduction in mismatch costs. It follows that

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

or equivalently

(19') $(1- \phi)R\tau > [M - \phi(a_i - x_j)^2]\tau.$

Moreover, Firm j will prefer the existing statute at s_E to the private provisions at $a_i \in [0,1]$ when

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

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 $\phi < \phi^0 = [R - M]/R$, even the firm with an ideal point at $x_j = a_i$ will prefer to form and organize under the existing mismatched statute s_E. At this point, as illustrated in Figure 1 when $\phi = .267$, K will then be negative for all firms with $x_i \in [0,1]$, and there will be no demand for the privately produced set of provisions at a_i.[14] Private lawdrafters therefore have no incentive to incur the costs (D) of producing non-law provisions even if they have enforceable property rights.

More generally, if $R > M$, the critical probability ϕ^c approaches 1 such that even slight uncertainty regarding the enforcement of the provisions at a_i reduces demand for these provisions. 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 adopt or sell the set of provisions contained in a_i without having to pay a licensing fee. This makes the private lawdrafter effectively a price-taker and drives the market price of its

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[14] The curve in Figure 1 is based on the following parameters: $\tau = .8$, $M = 1.1$, $R = 1.5$. Thus $\phi^0 = [R - M]/R = .267$.

product 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. Lawmakers may, however, 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. But byproduct lawmakers' incentives 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 that are inherent in the above model. Public lawmaking entails a political competition among interest groups (Becker). 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 public lawmakers, however, may be limited. First, even if a legislator can obtain state enactment of an innovative law, the law may not help the enacting entity increase its revenues because the law is not welfare-enhancing or the state cannot capture the benefits of any increased welfare the law produces. For example, 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. This public law may be entrenched network considerations as discussed above with respect to private forms. Also, because governments 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 governments have incentives to enact efficient and innovative statutes, individual legislators may have weak incentives to produce these statutes. Apart from legislators' inability to capture a significant share of the state's benefits from innovations, legislators risk reputational harm from failed experiments, backlash from interest groups injured by the innovation, and other jurisdictions' copying of successful statutes (Rose-Ackerman; Cumming & MacIntosh). More precisely, public legislators in HT's model have no incentive to innovate after state profits reach a certain level, and therefore no incentive to differentiate their statutes' price and location.

Given public lawmakers' weak incentives, public lawmaking can be expected to result in little innovation consistent with HT's model discussed above. For example, HT and Romano (1985) show that state corporation laws tend toward uniformity. Also, we have shown that states do not gain out-of-state formations from adopting innovative LLC statutory provisions (Kobayashi & Ribstein (2010).

Although innovation does not seem to give states an edge in interstate competition, significant statutory variation nevertheless exists in some contexts. For example, we document the existence of such variation in LLC statutes (Kobayashi & Ribstein 2010). 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 could lead to innovations that complicate the law and thereby create business for lawyers while imposing costs on the rest of society (Hadfield).

Because of public lawmakers' weak incentives, public lawmaking offers little or no advantage over private lawmaking. Private producers' extreme differentiation is either strictly better than the undifferentiated public provision outcome if the public outcome is skewed toward 0 or 1, or equivalent to this outcome if public producers happen to locate to locate midway between 0 and 1.

To see this precisely, consider a set of statues at s_i. The costs of mismatch equal

$$(20) \quad C^{UNIF} = \tau \int_0^1 (x - s_i)^2 f(x) dx$$

With a uniform distribution with range [0,1], $f(x) = 1$ and the costs of mismatch will equal

$$(20') \quad C^{UNIF} = \tau[\frac{1}{3}x^3 - s_i x^2 + s_i^2 x]\Big|_0^1 = \tau[\frac{1}{3} - s_i + s_i^2]$$

Mismatch costs are minimized when the statutes are located so the derivative of C^{UNIF} with respect to s_i is equal to zero

(21) $\dfrac{\partial C^{UNIF}}{\partial s_i} = \tau[-1 + 2s_i] = 0$

which yields $s_i{}^* = \frac{1}{2}$, and total mismatch costs equal to $\tau/12$. Thus, *if* public lawmakers locate their statues at the halfway point, total mismatch costs equivalent to that produced by the extreme differentiation result derived by HT private lawmakers.

HT note, however, that there is no reason for the public lawmakers to locate at the midpoint. Indeed, without a more detailed model of public provision there is no reason to predict any particular location of the public statute. If public lawmakers coalesce at a point other than the midpoint of the [0,1] range, total mismatch costs under the HT public lawmaker outcome will be strictly greater than that achieved by private lawmakers that locate at the extreme points. For example, suppose that the public lawmakers choose to locate their statutes at $s = \frac{1}{4}$. With a uniform distribution [0,1], the total costs of mismatch will equal:

(22) $\tau \displaystyle\int_0^1 (x - \frac{1}{4})^2 dx = \tau \int_0^1 [x^2 - \frac{1}{2}x + \frac{1}{16}]dx$

$= \tau[\frac{1}{3}x^3 - \frac{1}{4}x^2 + \frac{1}{16}x]_0^1 = \tau[\frac{1}{3} - \frac{1}{4} + \frac{1}{16}] = \tau\frac{7}{48}$

This is greater than the total mismatch costs under the extreme differentiation outcome of the private market with N = 2 which equal $\tau/12$. Indeed, if the location of the statute is randomly distributed over the [0,1] interval, the expected total mismatch costs will equal:

(23) $\tau \displaystyle\int_0^1 \int_0^1 (x - s)^2 dxds = \tau \int_0^1 [\frac{1}{3} - \frac{1}{2}s + s^2]ds = \frac{5\tau}{12}$

Public lawmaking not only may have less efficient outcomes than private lawmaking, but may reduce the incentives of private lawmakers. More precisely, an existing statute in the [0,1] interval can significantly decrease the returns to a private lawmaker from drafting and selling a statute located in that space. In the case of a private lawmaker drafting a single statute at $s = .5$ with no public statute in the [0,1] space, the lawmakers gross revenue will equal

(24) $p^L = \tau M - (.5)^2 = .63,$

under the assumption that $M = 1.1$ and $\tau = .8$. In contrast, gross revenues with a preexisting statute at .75 will equal .225*.1875 = .0422, or just 6.6% of the revenues in (24). Thus, a public statue can crowd out the incentive to produce a private statue, as the smaller net revenues available are less likely to cover the cost of drafting a statute F. In the absence of a private statute, total mismatch costs will be $7\tau/24$ as given by equation (22).
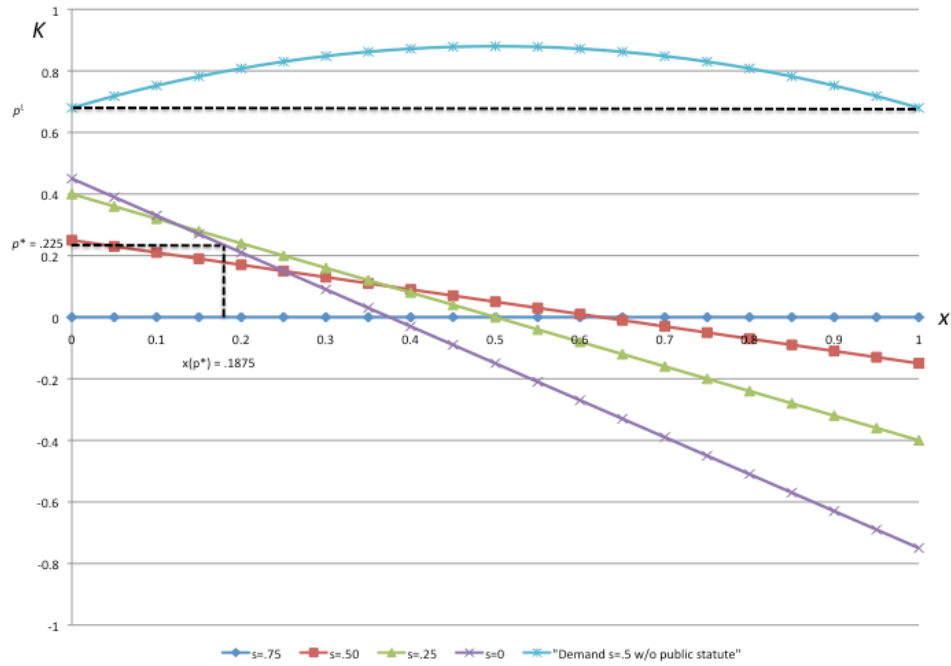
Figure 5 – K^{PRV} with Existing Public Statute at .75.

Figure 5 shows the demand for private statutes when there is a public statue at $s_u = .75$. The Figure shows that the existence of a public statue will alter both the location of any private statute and the returns to drafting such a statute. With respect to the location of the statute, profits for a private firm are strictly increasing in the distance between the private statute s_p and an existing public statute in the [0,1] interval if the cost of distributing the statue c is close to zero. Thus, a private lawmaker would prefer to locate its private statue at $s_p = 0$ under these conditions over locating the statute closer to the existing statute. Total mismatch costs with the public and private statute equal $1.21\tau/12$, which is higher than the mismatch costs associated with two private statutes extreme differentiation or a uniform private statute located at ½.[15]

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

Parts I and II show that neither public nor private lawmakers have the correct incentives to engage in innovation. Public legislators cannot capture much of government's revenues from

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15 Because only a small fraction of the firms in the [0,1] interval use the privately produced statute (those with ideal points between 0 and .1875), firms between .1875 and .25 incur higher mismatch costs than any firm in the equilibrium with two private firms with statutes located at 0 and 1.

innovation, while private lawmakers lack property rights in law. But this Part discusses a third approach to lawmaking -- that is, by non-politicians as a byproduct of other activities. Byproduct lawmakers derive their gains from political or other activities rather than from selling their model laws on the open market. As a result, they have an incentive to engage in lawmaking even assuming they cannot share in the political entity's revenues, as with public lawmakers, or lack intellectual property rights in their products, as with private lawmakers. Byproduct lawmaking thus helps explain why innovation in lawmaking occurs despite the incentive issues discussed in Parts I and II. However, these same incentives can skew byproduct laws away from social welfare compared to laws produced by purely private lawmakers property rights in their laws. Subpart A examines byproduct lawmakers' incentives and discusses some types of byproduct lawmakers. Subpart B discusses specific examples of byproduct laws.

A. BYPRODUCT LAWMAKERS

Byproduct lawmaking represents a hybrid between pure public and pure private lawmaking. Byproduct lawmakers facilitate innovation by public lawmakers by enabling lawmakers to outsource drafting costs to private interest groups. The interest groups, for their part, have an incentive to try to achieve their political goals by offering readymade laws to public legislators. Byproduct lawmakers are not offering statutes directly for sale to the market for standard forms, as in the standard model of private lawmaking, but rather as a way to enhance their lobbying or other business activities.

The differences between "byproduct" laws and laws produced in a pure market for private law derive from the lawmakers' incentives. Sellers of standard forms sold on a conventional market would seek a share of the combined producer and buyer surplus from commercial exchange. Bargaining over this surplus in an efficient market for forms increases social wealth. By contrast, the benefits byproduct lawmakers seek for those who provide their funding do not depend solely on what users will pay to minimize mismatch costs. Rather, byproduct lawmakers have an incentive to forego profits in a commercial market for law in favor of redistributing social wealth to their group. This incentive is likely to skew byproduct laws away from the mix of forms that would exist in an efficient market for private forms, although the amount of skewing will depend on the context.

To understand the potential effect of byproduct lawmaking, consider the promulgation of a uniform law proposal (see Subpart III.A.2, below) in the [0,1] interval, which state legislatures then uniformly adopt. Because uniform lawmakers' incentives differ from profit maximization, they will not tend to place the uniform statute at the midpoint of the range. For example, if the byproduct incentives of a uniform law proposal results in locating the statute as $s = \frac{1}{4}$, this would lead to the mismatch costs shown in (22) in Part II.

Byproduct lawmakers' incentives, like those of all groups, depend to some extent on the group's structure. Thus, a nonprofit lawmaking entity may embrace social welfare objectives to

a greater extent than a for-profit entity (Davis). However, this is far from clear. Moreover, there may be important incentive differences within the non-profit and for-profit categories. For purposes of this paper, we assume only that the entity is designed to maximize certain benefits for the group, and distinguish between the social welfare effects of selling the group's products in a market for laws and those of producing laws as a byproduct of some other activity.

A full welfare analysis would require balancing increased mismatch costs attributable to byproduct incentives against the increased value that some byproduct lawmakers can bring to lawdrafting. For example, although lawyers, uniform lawmakers and industry groups may have incentives to skew their products away from what would be produced in a product market, involvement of these groups arguably adds expertise and a higher likelihood that their products are adopted as law.

The following sections discuss some of the groups that participate in the political process by drafting laws as a byproduct of their other activities. Subpart B discusses examples of particular byproduct laws.

1. Lawyers as lawmakers

Apart from their role in litigation, lawyers play an important role in state lawmaking.[16] There is significant evidence of lawyers' participation in lawmaking activities (Macey & Miller; Goforth). Indeed, lawyer 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 earn reputational benefits 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.

Two aspects of the legal infrastructure of the U.S. favor lawyers' participation in lawmaking. First, 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. Second, state choice of law rules enhance the effect of licensing by linking the

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

application of a state's law to whether the client resides in, or litigates in the courts of, the licensing state (O'Hara & Ribstein, ch. 4). 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.

Lawyers have an incentive to shape laws to 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 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).

Lawyers' "byproduct" role is mitigated to some extent by their "quasi-property" right in state law which arguably aligns their interests with social welfare to a greater extent than other byproduct lawmakers (Ribstein 2004). Lawyers cannot make their states' laws too lawyer-friendly without driving potential clients to states with less lawyer-friendly laws. The extent to which lawyers' incentives align with social welfare varies depending on a variety of circumstances and conditions. If, for example, the choice of law rule is based on plaintiff's choice of forum, as with most product liability cases, lawyers might maximize their own and the state's interest by maximizing plaintiffs' interests rather than the parties' mutual interests. Lawyers' incentives also may depend on the nature of their practice. 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). And lawyers' incentives may vary with their state's power in the market for state law. Where a state like Delaware has significant market power in the market for state law, the pressure from state competition eases and lawyers are freer to indulge their incentive to seize a larger portion of a fairly stable pie.

2. 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[17] 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 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, may actually reduce the amount of efficient uniformity that would emerge without NCCUSL (Kobayashi & Ribstein 1996) 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, provide a venue for interest group negotiations. 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 many uniform laws, which maximize the need for legal advice, drafting and planning (Ribstein & Kobayashi, 143-44).

3. Lawmaking by interest groups

Interest groups can write laws 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, as with other byproduct laws, 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.

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[17] www.uniformlaws.org.

4. Industry groups

Industry groups engage in writing a wide variety of model law proposals and codes designed to deal with problems specific to the group.[18] Commercial law began with the rules merchant guilds wrote for each other and continues to be developed by numerous other trade groups, illustrated by Bernstein (1992)'s study of the diamond industry. 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. Several organizations write codes and standards that are used by the groups and referenced by lawmaking bodies.[19] These laws, as well as customs developed by particular industries, are designed to fit the group's norms and business practices and may be enforced via reputational sanctions.

Industry groups can internalize the costs and benefits of their rules vis-à-vis group members. At least where the industry is relatively small, its rules may fully reflect the interests of all of the firms in the industry. But even in this situation, the rules may not reflect the industry's customers or others affected by the rules. Thus, like other byproduct laws, industry group laws and codes may be mechanisms for redistributing wealth via markets or political means to the law drafters. 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. For example, judicial decisions may reflect lawyers' interests in complicating the law and promoting litigation rather than the industry's interests in clarification and simplification (Bernstein 1996).

5. Common law: litigants as lawmakers

Parties to private litigation in effect contribute to legal innovation as a byproduct of their disputes when they have judges resolve their disputes. 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. Moreover, courts[20] and state legislatures[21] have resisted litigants' efforts to restrict public access

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[18] These efforts are part of a broader category of the production of "boilerplate" contract provisions. In many cases these provisions are not intended to be laws and therefore are outside the focus of this paper. For a discussion of the production of this boilerplate see Davis.

[19] For example, several of these groups were listed as amici in the *Veeck* case, 293 F. F. 3d at 796, n.6: Building Officials and Code Administrators International (BOCA), International Code Council, International Conference of Building Officials, American Medical Association, American National Standards Institute (ANSI), American Society of Association Executives (ASAE), American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE), American Society of Mechanical Engineers (ASME), National Fire Protection Association (NFPA), Texas Municipal League, and Underwriters Laboratories, Inc. (UL).

[20] *See* Miller. For cases refusing to seal court records, *see* Brown v. Advantage Eng'g, Inc., 960 F.2d 1013,

to legal proceedings through confidentiality agreements and protective orders. Some litigants may be willing to bear the extra costs of lawmaking as the price of better law and decision-making. The resulting process accordingly may produce efficient law (Rubin) even if it is a byproduct of the separate activity of dispute resolution. But the extra costs of producing judicial decisions and the potential loss of confidentiality often induces the parties to settle (Kobayashi; Lederman; Friedman & Wickelgren; Fiss) or to resolve disputes through private arbitration.

Given private parties' limited incentives to create common law, our theory would predict that private lawmaking with respect to common law would be in the form of byproduct laws. Indeed, there are at least two important categories of such laws. First, class action plaintiffs are a special type of litigants involved in creating law. These cases often involve remedies under public laws, such as the discrimination laws, which involve problems different from the sort of standard forms that are the focus of this paper. However, in cases such as corporate derivative suits and some types of consumer contract cases, class actions produce results that resemble or are aspects of market structures or standard form contracts. 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 who use litigation to create an asset in the form of a recovery or settlement (Kobayashi & Ribstein (2004)). The legal resolutions entailed in class actions are, in effect, sold to lawmakers (i.e., courts) rather than in broad commercial market for legal forms. This produces innovations skewed toward the lawyer-entrepreneurs' interests in maximizing their fees rather than reflecting the mix of rules that would minimize firms' mismatch costs. Class actions accordingly resemble byproduct laws.

Second, the common law may be the byproduct 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' private incentives.

B. BYPRODUCT LAWS: THE CASE OF LLCS

This subpart provides some specific examples of private lawmaking that is a byproduct of the lawmakers' other activities, focusing on the development of limited liability companies (LLCs). These laws illustrate the central problem of byproduct legislation: the incentives that motivate this lawmaking can spur more innovation than either public lawmaking or private lawmaking under the current weak property rights regime. These new laws can reduce firms' mismatch costs compared to the situation without the byproduct laws. At the same time,

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1014 (11th Cir. 1992); Wilson v. Am. Motors Corp., 759 F.2d 1568 (11th Cir. 1985).

[21] *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.

byproduct lawmakers' incentives can divert these rules from first-best laws designed to maximize social welfare as illustrated by the mismatch costs shown in (22) in Part II.

1. The development of LLCs

The LLC ultimately filled the need described in Part I.A. for a small business form that combined the general partnership's flexibility with corporate-type limited liability. Legislative experiments with such a business form had failed in the 19th century (Gazur and Goff, 393-94; Guinnane et al at 37-38). Guinnane et al attribute the failure to the conservatism of common law courts and to states' refusal to enforce sister states' statutes. This fails to account for why state legislatures and courts did broadly embrace the corporate form. A more complete explanation focuses on states' unwillingness to extend owners' limited liability beyond the controlled corporate setting and the federal government's insistence on taxing such firms as corporations (Ribstein, 2010, Chapters 4-5). For present purposes what matters is that state lawmakers lacked adequate incentives to provide a standard form that firms clearly demanded. This caused firms to incur higher mismatch costs than under a regime that produced an optimal variety of forms.

Private lawmaking efforts ultimately broke the impasse. An oil company, working though its lawyer, promoted 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 partnership. 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 ultimately prompted a federal tax ruling classifying an LLC as a partnership for tax purposes.[22] This ruling spurred the eventual adoption of LLC statutes in every state. Broad state acceptance, in turn, persuaded the IRS to eliminate most tax impediments on limited liability business forms.[23]

The creation and evolution of the LLC illustrates the relationship between byproduct lawmaking, public lawmaking and jurisdictional competition in producing legal innovation. Public lawmakers alone had little incentive to invest effort and political capital in developing a new limited liability vehicle for which there would be little demand because of tax restrictions. Private parties, meanwhile, lacked the property rights sufficient to motivate an effort to craft a socially efficient mix of standard forms for this market. The work was done by byproduct lawmakers, including business lawyers seeking clients and taxpayers in industries like oil and gas seeking particular tax benefits.

The development of the LLC indicates that significant legal innovation can occur. This conclusion is confirmed by evidence of variation in LLC statutes (Kobayashi & Ribstein 1996;

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

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

Kobayashi & Ribstein 2010). This contrasts with evidence of corporate non-differentiation that HT cite in support of their model. Yet state LLC innovations were not correlated with state revenues from LLC formations (Kobayashi & Ribstein 2010). This suggests that lawmakers must have had other incentives to engage in innovations. The byproduct theory helps explain why these innovations occurred.

2. Estate freeze provisions

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 benefits from statutes that facilitated tax breaks and limited liability. Lawyers' pursuit of these benefits, in turn, helped skew the statute from first-best terms.

An example is estate freeze provisions in state unincorporated business statutes. Business owners often seek to pass their firms onto their heirs. A business owner might ensure continuity of the business by forming a limited partnership or LLC and making the owner's potential heirs limited partners or non-managing LLC members. The surviving members would take control of the firm after the founder's death. However, estate and gift taxes on the transfer could force the children to liquidate the business and thereby defeat the business owner's goal. One way to avoid this result could be to make the shares non-transferable, which theoretically would reduce their market value and therefore the tax on the transfer. 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.[24]

Private lawmaking again intervened to fill a gap in state business forms. 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. 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 benefit from these statutes through increased estate planning fees these provisions would encourage and decreased malpractice risk because the statutes' default rules ensured that firms would meet clients' tax objectives. 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 their own benefits from increased use of limited partnership and LLC statutes as estate tax avoidance devices. Lawyers' motivations might have skewed the statutes away from more efficient

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

approaches to designing the partnership and LLCs that traded off tax advantages to some firms of an estate freeze against the disadvantages of locking minority owners into closely held firms. One such approach might be a separate statutory form specifically designed for family firms. Lawyers had little interest in "selling" alternative laws that would not attract additional business, could reduce lawyers' fees from crafting customized contracts, and could pose a malpractice risk to lawyers who failed to advise clients of the tax implications of choice of form. On the other hand, the alternative provisions might be produced by purely private lawmakers seeking to sell their laws rather than to use the laws to pursue tax or other objectives.

3. 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). These modifications enabled LLCs to 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).

4. L3Cs

Statutes providing for the "low profit limited liability company" (L3C) (Ribstein & Keatinge, §4:10) illustrate the role of another type of byproduct lawmaking in the evolution of LLCs. These statutes are intended to facilitate investments by private foundations that seek exemptions as non-profits under Section 501(c)(3) of the Internal Revenue Code. The foundations may be assessed excise taxes if they make investments that jeopardize their charitable purposes. Congress enacted provisions in the Tax Reform Act of 1969 for "program related investments" (PRI) that would not have this result and therefore would avoid excise taxes that otherwise would be imposed on the foundation's business holdings (Callison & Vestal, 276-79). However, few foundations were using PRIs 40 years after the birth of the concept (Callison & Vestal, 273, n. 4), perhaps because of ambiguity over the definition of PRIs. L3C statutes are intended to solve this problem by creating a form of entity that is clearly limited to charitable-type purposes.

Significantly, the L3C germinated not in a legislature but in a presentation by foundation head Robert Lang at the Aspen Institute's 2006 meeting and follow-up by participants (Schmidt, 165, n.9). The foundations were looking to clarify the PRI tax break and thereby make it more valuable. Although amendment of the tax law or a tax rule would have been the surest way to

provide this clarification, the L3C's proponents may have hoped that state statutes would provoke federal clarification.

The L3C's proponents might argue 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 do not fit squarely into either the for-profit or non-profit categories. Entrepreneurs may want profits plus something other than financial gain. For example, they may want to invest in projects that are socially valuable but too risky to be considered positive net present value. These firms may need standard form provisions that differ from those which match the needs of standard for-profit firms.

The L3C arguably facilitates this type of innovation in two ways. First, it mitigates the uncertainty that has hobbled the PRI by providing a state statutory safe harbor that enables the federal tax exemption. 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 must serve both society and markets (Tyler). Although existing business associations let managers of basically for-profit firms 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 not only provide guidance for managers, but also help signal the firm's objectives to investors and customers (Schmidt). In terms of our model, L3C statutes occupy a location in the map of standard forms that reduces the mismatch costs of this type of firm.

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 enables 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 state law 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. To be sure, L3Cs provide a mechanism for clarifying the tax rule -- that is, a readymade business association that the PRI definition can refer to. But it is unlikely this will lead to legislation that 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.

Our point is not that the L3C lacks social value, but that it illustrates the compromise nature of byproduct laws. 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.

IV. LAW AS A PRODUCT

Parts II and III discussed significant problems with public and byproduct approaches to lawmaking. This Part shows how these problems might be reduced by mechanisms that encourage more direct private investment in law-creation. In particular, these mechanisms must address the problems inherent in the current "Hobson's choice" of private lawmaking: the lack of private property rights in law, and the need for certainty that only law can provide. Subpart A elaborates on current intellectual property rights in law and proposes changes in this law that could enhance private lawmaking. Subpart B discusses private contractual alternatives that may fill some of the gaps in intellectual property law.

The model of private lawmaking discussed in Part I raises two types of problems that need to be addressed in designing property rights in law. First, in order to give private parties the incentive to produce laws, these parties need to have property rights to specific laws. This would entail something like copyright protection, except redesigned from current law to better balance the public's access rights and the author's right to exclusive ownership. Second, in order to protect against excessive production of laws, some entity must have monopoly rights to the space occupied by competing statutes. This could include patent rights, but more likely will involve other approaches, including government ownership of the space. Subpart A below discusses property rights in specific laws. Subpart B discusses the creation of broader monopoly rights in areas of law.

A. SPECIFIC LAWS: COPYRIGHT

Copyright is the primary mechanism for protecting authors' rights in specific laws. As already discussed, current law restricts the availability of copyright for privately produced materials a government entity adopts as law. 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."[25] This definition extends to court opinions

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[25] 17 U.S.C. Section 101, 105.

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.[26] 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.[27]

The potential social welfare benefits of private lawmaking and the importance of property rights in achieving those benefits suggests Congress should explicitly extend some copyright protection to at least some private materials that have the effect of law. This could involve balancing the public's access rights with the lawdrafter's property right by giving private lawmakers some rights short of the full-fledged control inherent in a private property regime. For example, the parties to a case or their lawyers could copyright 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.[28] Thus, the creator of a model building code could post a code on a website with a licensing agreement and retain its property rights even if a municipality adopts the code. Alternatively, a government entity could buy the statute outright and license it to other governments while giving the public access to it. As long as the system results in a public benefit of additional, more innovative, law, the public should be willing to pay the cost.

Permitting copyright of privately produced materials adopted as law would resolve a contentious policy debate between the majority and dissenting judges in the leading case on the issue -- the Fifth Circuit's 2002 en banc opinion in *Veeck*. The majority opinion broadly held that

> public ownership of the law means precisely that "the law" is in the "public domain" for whatever use the citizens choose to make of it. Citizens may reproduce copies of the law for many purposes, not only to guide their actions but to influence future legislation, educate their neighborhood association, or simply to amuse (Veeck, 293 F. 3d at 799).

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[26] *See supra* n. 2.

[27] *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).

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

The majority reasoned as a policy matter that the author of the material had survived without copyright protection and likely would continue to promulgate codes for its own purposes even without such protection. However, even the majority opinion recognized exceptions. For example, it suggested that the code author would be protected from publication of material in the model code that was not part of the law (id, n. 14) and from publication of the model code itself as distinguished from statutes based on it (id at 804), and suggested a distinction between publication of a law based on the code and the law's reference to the privately prepared standards or other materials.

Two dissents questioned the breadth of the majority's rule and its application to a case involving publication of copyrighted codes on a website and there was no evidence that anyone was actually denied access to the laws. Both dissents noted the need, particularly of smaller government entities, to outsource law-drafting services to code preparers (293 F.3d at 807, Higginbotham, dissenting; id at 817, Wiener dissenting).

Perhaps most importantly for present purposes, Judge Wiener answered the majority's argument that code preparer's could and would continue their work without copyright protection:

> Continued maintenance of a revenue source from sales of codes to individual owners, architects, engineers, materials suppliers, builders and contractors as well as libraries and other more attenuated purchasers, all of whom buy copies of the codes directly from SBCCI, serves another public interest. I refer to the continuation of SBCCI's independence from the self interest of its dues-paying members, who otherwise might be in a position to command more influence were SBCCI forced to obtain too great a share of its revenue from such supporters. Clearly, SBCCI's receipts from sales of the codes substantially reduces the potential for greater dependence on its membership, presumably allowing SBCCI to operate without becoming entirely beholden for its existence to self-interested entities (293 F. 3d at 817).

This argument implicates our distinction between "byproduct" laws and those prepared for the main purpose of sale to users. As discussed in Part III, laws drafted by private parties incentivized by property rights would be more likely to reflect firms' actual needs than byproduct laws, which are aimed at redistributing social wealth to the interest groups that are drafting the laws.

As we have examined in earlier articles, there are other limitations on copyright protection that are not considered here. For example, there is the question of merger, in copyright, where otherwise copyrightable original expression become merged with the underlying idea, and thus is no longer protected under copyright law. Such a limitation likely applies to statutes, where a particular expression, adopted as law, becomes merged with the underlying idea (legal enforcement of a term or provision). See Kobayashi & Ribstein (2011).

B. RIGHTS AS TO TYPES OF LAWS

We show in subpart I.B that a private lawmaker with property rights to all model laws located in the interval [0,1] has incentives under some conditions to produce an optimal number of statutes in this interval in the sense that the total cost of producing the statutes is less than the savings in mismatch costs produced by the statutes. Thus, if lawmakers can be given adequate property rights, the main problem is limiting these rights in situations where the conditions of optimality do not hold. The more important problem for present purposes is how to create property rights over the interval so as to encourage the production of an optimal amount of law where the requisite conditions do hold.

Creating monopoly rights over the relevant space cannot be done through conventional intellectual property law. To begin with, copyright-type rights in a particular law discussed in section 1 would not bar a competing statute in the space that has the same or a similar purpose but different language.

Patent-type rights in a legal idea may come closer to securing the space but are still inadequate. Such rights face high hurdles under rules defining patentable subject matter and requiring non-obviousness (Kobayashi & Ribstein 2011). Even if these hurdles could be overcome, the rights conferred in a particular idea still may not cover the relevant territory. For example, a patent for a "poison pill" takeover defense, a possibility we discussed in our previous article, might cover takeover defenses that use anti-dilution mechanisms. Such protection might be enough to encourage production of other types of socially beneficial legal ideas. However, the patent would not cover all takeover defenses or even all director-approved takeover defenses. Producers therefore would have private incentives to create other types of takeover defenses beyond the point where total drafting costs exceeds mismatch cost savings. Similarly, a patent for a limited liability company would not cover other limited liability standard forms for closely held firms.

For similar reasons optimal property rights could not be created simply by modifying antitrust laws to allow private lawdrafters to combine into firms that monopolize a given space. The problem here is that of new entrants which can imperil any monopoly. Even if network effects increase the robustness of a private law monopoly, changing circumstances can always increase the mismatch costs in a given equilibrium, thus creating a market opportunity for new providers. The existing monopoly provider cannot prevent overproduction of statutes unless it has exclusive legal rights to the space.

An alternative to intellectual property rights in achieving monopoly rights over types of laws is for private lawdrafters to license or sell their copyrighted laws to government entities. As discussed in Section 1, under our proposal the lawdrafters would retain the right to profit from sale or licensing of the laws to government entities as long as those subject to the law are assured access to it. The purchasing or licensing governments would have monopoly rights defined by

the choice-of-law rules that apply to each type of law (O'Hara & Ribstein). Some types of laws, such as the building code in *Veeck*, apply to all relevant activities within the government's territorial space. Other types, such as those applying to the internal governance of corporations and other business associations, apply based on the parties' choice. In either case, the government is empowered to decide how many and what types of laws to enact within the relevant space. Thus, Delaware can decide which takeover defenses Delaware corporations can adopt and how to apply these defenses, as well as the menu of small company statutes available to firms choosing Delaware law. To be sure, the government cannot prevent the entry of new private providers. However, government will retain monopoly rights over "law" as we have defined it -- i.e., rules that will be enforced with $\phi = 1$.

Relying on *government* acquisition of private forms may seem an odd way to promote optimal *private* law production. In particular, this might appear to return to the problems of inadequate law production that private lawmaking is intended to solve. However, relying on government purchase of private law would maintain the key advantage of private law production -- that is, inadequate public investment in *drafting* new laws. Government purchasers of private laws would, in effect, outsource law drafters to private providers, comparable to the municipal adopters of the building codes involved in *Veeck.*[29]

There are several possible alternatives for combining private lawdrafting with government enforcement. States might, for example, 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 in effect create the opportunity for an "aftermarket" for standard forms. The open-ended statute would give all of these privately created standard forms some of the effect of law. Interpretation problems might remain which would need to be addressed by additional law in the form of specific statutes or court decisions.

Government's involvement under our proposal would not necessarily raise the problems of byproduct lawmaking. Private lawdrafters would produce laws for sale in a market which includes both multiple governments and private buyers such as associations. Unlike byproduct lawmakers, the lawdrafters would not be seeking political or other advantages apart from profits from sales. Unlike the current system defined by cases like *Veeck,* private lawdrafters would retain property rights even if their products ultimately become laws. Accordingly, their incentives to produce these laws would not be reduced by the risk of losing property rights as a result of government adoption.

The biggest problem with having to rely on government purchasers to produce optimal property rights in law is that governments may not act like private purchasers of laws. In

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[29] This unbundling of lawmaking and enforcement is analogous to a proposal for European corporate lawmaking (Painter, Kaal and Kirchner).

particular, government agents may have political incentives to buy too many or too few laws compared to profit-maximizing private purchasers. Indeed, these incentives produce the skewing from social welfare that we noted above with byproduct laws such as L3Cs.

The mechanism for addressing imperfections in the government market for private laws is jurisdictional competition. Governments would compete with each other not only regarding the outputs of their legislative agents, but also decisions by their government agents as to which private laws to purchase. This would be analogous to the situation that currently exists with byproduct lawmaking, where a state legislature like Delaware relies almost completely on lawyers to write business association laws.

In short, our proposal for private lawmaking complements public lawmaking disciplined by jurisdictional competition. We, and HT, have shown that public lawmakers have inadequate incentives to draft laws because of their inability to capture the rents from successful laws. Giving public lawmakers property rights in the laws they draft (Clowney) would not solve this problem because even with property rights they would still be unable to capture a share of any rents earned by their public employers. Giving private lawmakers property rights in their products that they can sell or license to government helps solve this problem because the government purchasers would capture the benefits of the laws in the market for state laws, just as Delaware has from the laws written by its lawyers.

Our analysis provides an additional reason to favor jurisdictional competition and federal systems over unitary systems and rules that impede jurisdictional competition. At first glance this may seem counter-intuitive, since multiple jurisdictions appear to complicate assignment of property rights and the creation of monopoly rights over types of laws. But as discussed above, choice-of-law rules can be seen not just as procedural rules but also as rules that create monopoly power over laws in a given space. Once we add property rights in privately created laws, the apparent incentive disadvantages of multiple jurisdictions dissipate. The advantages of jurisdictional competition in disciplining the market for laws then emerge as dominant. By contrast, a unitary system, by foregoing the advantages of competition, would be relegated to byproduct-type lawmaking, in which private lawdrafters must compete for political advantage.

The main alternative to a government market for private laws would be to find some way that private enforcers could provide government-like legal certainty. Such a regime likely would work only in a closed system like the world of the diamond merchants in Bernstein's (1992) study where notice is no problem and the parties are subject to strong reputational constraints. This kind of system theoretically could produce private common as well as statutory law. The challenge in a private common law system is finding a mechanism for internalizing the cost of producing judicial-type opinions. Although the parties to a private arbitration could agree to pay the arbitrator to produce a written opinion, 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. 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.

V. CONCLUDING REMARKS

Legal innovation is important, but may be under-produced 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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