LEGAL PROCESS FOR FOSTERING INNOVATION

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INTRODUCTION

This paper shows that innovation depends at least as much on how laws are made as on *a priori* analyses of the optimal content of those laws. Legal process therefore is critical to the development of efficient policies for fostering innovation and growth. Of particular importance is whether the U.S. legal system promotes an efficient market for law. Our analysis builds on central insights of Austrian economics and the role of institutions in supporting market processes. We begin with a brief introduction to Austrian economics. We then show how, in the light of these basic principles, particular legal institutions can foster innovation by supporting a market for law. The remainder of the paper illustrates this theory with specific examples.

Austrian economics and legal institutions

Austrian economic theory shows how market-based institutions enable prices to reveal preferences and thereby guide the behavior of economic actors toward greater efficiency. Austrian economists created a theory of competition as a process of dynamic efficiency characterized by discovery and creativity. A key aspect of this theory is Ludwig von Mises's (1949) conception of the market as continual human action which can shift the production possibility curve and not just move prices toward equilibrium as in traditional market theory. Schumpeter (1975) conceived the notion of "creative destruction" to describe such economic shifts. Kirzner (2000) added a focus on the entrepreneur's role in coordinating social action by finding arbitrage opportunities.

An Austrian economic concept that has particular importance for the present paper is Frederick von Hayek's (1945) insight that experts, academics, and lawmakers lack the necessary knowledge to make decisions about which legal and regulatory structures maximize welfare. Hayek emphasized that even the most brilliant and thoughtful policymakers cannot take account of the enormous number of political, social, technological and economic variables that determine how their plans will operate in the unknowable real world of the future. In order to deal with this knowledge problem, Hayek championed the market system as a vast network that can produce the necessary information.

Austrian-type market processes must be supported by appropriate legal institutions. First, legal processes need to be able to harness market-like mechanisms to create an information network that leads to the discovery of better policies over time. Second, legal institutions can encourage entrepreneurial activity by reducing incumbent firms' control of the political process. We show how both objectives can be achieved by enhancing the potential for jurisdictional completion.

Law markets and the information problem

To understand the scope of the information problem involved in regulatory design, consider the broad array of approaches to regulating contracts – mandatory vs. default rules, opt-in vs. opt-out, disclosure vs. substantive duties. In general, legal rules must be designed to balance solutions to specific problems in the market against the need to allow parties the freedom to engage in innovation. These rules sometimes should sometimes restrict opportunistic conduct in order to encourage trade or investment while at other times enabling the parties to craft their own agreements. Legal rules also can reduce information costs or transactional frictions and increase property rights. Individual policymakers, however, lack the knowledge or foresight to see all the potential alternatives or figure out which should be adopted in particular circumstances. Among other things, they cannot determine all of the immediate costs of regulation, the interaction among rules, the effect on incentives, or the long-run value of prohibited conduct.

The knowledge problem is particularly challenging in determining how to maximize long-term growth. Indeed, short-term efficiency-enhancing rules may prove to be wealth reducing in the long term. For example, even if intellectual property rights clearly promote innovation now, locking up ownership rights in those innovations for long periods may have unpredictable effects on the production of new information and products that build on existing information. These questions can be addressed only by experimenting with and observing the effects of different rules over time.

In order to solve the knowledge problem and to create efficient legal technologies, the legal system can use the same competitive process that encourages innovation in the private sector – that is, competition among suppliers of law. As we will see, this entails enforcing contracts among the parties regarding the applicable law. The greater the knowledge problem the more necessary it is to unleash markets for law to solve the problem.

Enhancing entrepreneurship

Legal process can enhance entrepreneurship by reducing incumbents' ability to block the path of new entrepreneurs that are essential to Austrian-style dynamic efficiency. This can be done by supplementing the “voice” of the political process with the power of exit, drawing from Hirschman’s (1970) famous analysis. The political process tends to favor the interests of today’s economically powerful firms over the small and not-yet-existing (or yet-to-be relevant) innovators of tomorrow’s potentially leading firms. Incumbent firms not only have significant resources to fund political activities but also a strong incentive to spend those resources so as to block innovation. After all, these firms’ are threatened much more by potential extinction by brand new industries and technologies than they are by their competitors’ potential erosion of their share of the existing market.

It is difficult to give future firms more voice without significantly altering the political system. But firms also can influence policymaking by deciding where to locate their businesses. Firms’ exit or potential exit can activate interests in the state who would be injured by this exit, including suppliers, customers, lawyers and workers. These groups would then enter the political mix in opposition to the incumbent pro-regulatory interest groups. Through this process exit becomes political voice becomes efficiency-driven economic policy.

Balancing costs and benefits of jurisdictional competition

Critics of enhancing jurisdiction point out that it can lead to a "race to the bottom" in which jurisdiction enact laws that favor particular parties rather than enhancing social wealth. For example, if the rules on jurisdictional choice emphasize enforcement of the parties' contracts for the applicable law, laws might favor expert and economically powerful manufacturers and sellers and undermine efficient state laws aimed at these parties. Jurisdictional choice also may favor economically mobile capital and systematically harm less mobile labor. Jurisdictional choice therefore could replace the defects of political choice with a different set of defects associated with exit.

There are several responses to these criticisms of enabling more jurisdictional choice. A first potential response is to emphasize the problems of enforcing restrictions on jurisdictional choice. In particular, if states or other jurisdictions can override choice and impose their regulation on parties they can haul into their courts, the determination of which laws to apply could depend on considerations such as plaintiffs' trial lawyers' decisions where to sue. This could introduce different but equally perverse legislative incentives.

A second response to criticisms of jurisdictional choice is that a system that favors the dynamic growth potential of the firms empowered by greater jurisdictional choice may increase social welfare more than a system that focuses on avoiding static inefficiency caused by wealth-transferring regulation. Even if economically incumbent powerful firms could gain from greater ability to avoid regulating states, these firms already have leverage in crafting regulation, and sometimes use this leverage to increase costs for potentially innovative competitors. Increasing innovative firms' ability to choose the applicable law therefore may increase the political power of these firms relative both to incumbent firms and to other pro-regulatory groups, thereby leveling the political playing field. Also, because growth has a potential multiplier effect on social wealth, the positive effects of systemic rules that enhance growth may swamp their negative effects from short-term deadweight losses.

Third, and most importantly, criticism of jurisdictional choice must proceed against a background of inevitable jurisdictional choice and competition in a multi-jurisdictional world. No single jurisdiction can reach all transactions in a global economy. Nor would we want it to, for the result would be duplicative regulation and chaos. Economic actors therefore inevitably can choose the jurisdiction whose laws govern their transactions. Thus, the relevant question is how to establish the best possible system of jurisdictional choice for maximizing growth in a multi-jurisdictional system.

LAW MARKET INSTITUTIONS THAT COULD BOOST INNOVATION

Our proposal for institutional reform to enhance jurisdictional choice draws on earlier work concerning a particular mechanism for jurisdiction-selection -- that is, contracts for the applicable law (O'Hara and Ribstein 2009). Specifically, we suggest harnessing the power of jurisdictional competition among the states through a federal law enforcing contracting parties' choice of law except to the extent states legislatively override the choice of law and regulate local transactions. This proposal serves the objectives of Austrian economics by providing a mechanism for experimentation and discovery while preserving space for entrepreneurs to enhance dynamic efficiency.

Our proposal seeks to channel jurisdictional competition toward efficiency by balancing the benefits of exit and jurisdictional competition against those of empowering governments to address local problems. By preserving a space for regulation, our proposal protects innovation by government as well as by the private sector. At the same time, the proposal uses both exit and voice mechanisms to discipline inefficient regulation.

In order to provide context for our suggested reform, this section discusses specific aspects of the system for choosing the law applicable to particular disputes. We focus on the particular context of the U.S federal system. This system's general features illustrate basic issues regarding jurisdictional choice, including the existence of multiple jurisdictions from which economic actors can choose, individual jurisdictions' incentives to favor local interests over systemic benefits of jurisdictional choice, the role of alternative adjudication mechanisms as a way of alleviating these problems, and the potential for coordination by a federal government or equivalent institution.

State choice of law rules

Choice-of-law rules focus on two types of decisions. Under conventional choice-of-law rules, courts choose which law applies to a particular transaction "ex post" when litigating a case arising out of the transaction. U.S. courts generally apply vague choice of law rules with results parties cannot reliably predict prior to litigation. These rules enable courts to apply local law, which effectively lets whoever controls the litigation forum – usually the plaintiff – choose the law. Plaintiffs' lawyers accordingly have an incentive to promote rules that encourage lawsuits in the states where they are licensed, and perhaps also rules that make these suits more costly for defendants. Courts and legislatures, in turn, have an incentive to come up with rules that cater to this powerful interest group. The only qualification is that states would not want the rules to be so harsh to defendants that firms would avoid jurisdictional contacts that subject them to suit in the state.

By contrast, changing the rules to focus on "ex ante" choice of law involves enforcing contracts that choose the governing law at the time when the parties make their deal. States that enforce these contracts have an incentive to design their laws so as to attract as residents and litigants parties who value contract enforcement. By enforcing property rights and contracts, these laws provide a secure basis for innovation and a potential escape route from other states' excessive regulation of contracts. The problem with contractual choice of law is that it can enable evasion of rules intended to protect the contracting parties or non-parties. The competition facilitated by ex ante choice of law therefore may turn into a "race to the bottom" where jurisdictions adopt socially inefficient rules to appeal to the parties that control the contracting process.

The alternative approaches to choosing the applicable law raise the question whether the inefficiency resulting from empowering trial lawyers under ex post choice is greater than the potential inefficiency from a race to the bottom that might result from ex ante choice. Moreover, whatever the answer to this question, it is difficult for states on their own to avoid both horns of the dilemma. Parties always have some power to avoid subjecting themselves to the jurisdiction of heavily regulating states, while states have some power to avoid applying the law selected by contractual choice of law clause entered into by parties that are subject to their jurisdiction. As discussed below, it may be necessary for the federal government to act as an umpire to guide the system toward efficient outcomes.

Federal substantive regulation

One approach to resolving the problems with multiple state laws would be to apply a single federal standard and thereby eliminate the inefficient outcomes of state choice of law discussed above. However, the application of a single federal law inhibits the potential for state law competition and discovery that is essential to support Austrian market processes.

To be sure, enactment of a federal statute is followed by a common law process of judicial interpretation which has elements of an Austrian discovery process. Statutes can be designed with this process in view (Hylton 2003). However, such a process brings problems of its own. First, the interpretation process is tethered to the statute and therefore may allow less discovery and innovation than the sort of competition among multiple jurisdictions that can occur under an efficient state law system. Second, even a federal law designed to enable evolution may inhibit entrepreneurship by protecting incumbent firms. Third, a federal statute designed to maximize common law development may provide less certainty than state legislation coupled with a federal choice-of-law statute as discussed below.

State initiatives

Federal substantive law is not the only way to improve state legal competition. Individual states have incentives to engage in process innovations that attract firms to locate headquarters or factories in their states in order to increase the possibility that their cases will be litigated in the innovating state's courts. The innovators here are legislators, individual lawyers and bar associations who essentially serve as legal entrepreneurs. Arbitration and business association law have developed partly as a result of this legal entrepreneurship. Several states have adopted choice-of-law statutes which clarify that choice of law clauses will be enforced in certain types of contracts, mainly large commercial contracts.

The potential for process innovation by the states is indicated by a Delaware court rule (Delaware Chancery Court Rules 96-98 (February 1, 2010)). The rule essentially turns Delaware's respected Chancery Court judges into private arbitrators. Contracting parties can agree to have their case governed by the new procedures before a Delaware chancellor with direct appeal to the Delaware Supreme Court. The new rules represent a convergence of private arbitration and public judicial procedures.

This state-private convergence theoretically could be taken a step further by Delaware judges retiring from Delaware public life and going private. Other states also might hire the judges and adopt Delaware law, thereby competing with both Delaware law and infrastructure. Perhaps a central agency could be developed for accrediting roving judges. As more states have an opportunity to become viable competitors in the law market, they have greater incentives to change the choice of law rules to better accommodate state competition.

A problem with all state initiatives, however, is that they are ultimately subject to being trumped by uncooperative states. As long as a plaintiff can get jurisdiction in a state that has not signed onto the procedure, the forum state has some power to disregard the contract's choice of the innovative state in favor of enforcing local regulation. This suggests that federal law, despite its potential for inhibiting state experimentation, may have an important role to play in providing the institutional base for Austrian-style legal market processes.

Federal choice of law statutes

Instead of providing for specific regulation, federal law can promote discovery and innovation by harnessing the state law process while ameliorating its worst problems. This could be done through a federal statute that provides for the enforcement of contracts regarding the applicable law.

One approach is for federal legislation designating the types of choice of law contracts that are or are not enforceable. But designing this regulation would implicate the knowledge constraints on policymaking discussed above.

Federal law could instead impose procedural constraints on state laws blocking enforcement of choice of law contracts. In particular, a federal statute could specify that choice of law contracts can be invalidated only pursuant to state legislation and not by judicial decisions (O'Hara and Ribstein 2009, Chapter 10). This would serve two purposes. First, using the legislative process would promote robust competition among interest groups, which in turn can maximize welfare (Becker 1983). Specifically, as discussed above, interest groups who are hurt by firms' exit would join in opposition to the regulation with those more directly injured by it.

A second advantage of the proposed approach is that requiring clarification of the rule by embodying it in legislation would better enable firms to select jurisdictions in which to do business based on their enforcement of choice-of-law contracts. This would encourage jurisdictions to take firms' interests into account when deciding on enforcement.

Although this approach would enable states to inhibit experimentation and discovery by imposing regulation, the procedural limitations suggested above would interact with other limits on state regulation to move the system toward efficiency. First, as noted above, firms would retain their ability to avoid states that impose excessive regulation, thus forcing states to choose between regulating and enabling exit.

Second, the federal choice-of-law solution could encourage interstate recognition of contractual choice of law if the federal law were backed by an implicit threat of federal regulation and preemption of state law if the states insist on promoting parochial local interests and refuse to enforce even reasonable sister state laws that parties select in their contracts. The crafting of preemption to further markets for law is discussed below.

A potential problem with the above proposal is that giving legislatures the exclusive opt-out power foregoes the benefits from judicial decisions whose random mutations can spur efficient legal evolution (Butler 2006). However, these beneficial mutations are more likely with respect to complex substantive issues than for the relatively simple question of whether or not to enforce contractual choice of law. In any event, these potential benefits of judicial mutation must be balanced against the costs of lower predictability, notice and political transparency.

Federal choice of forum and arbitration

Parties can help ensure enforcement of their choice-of-law contracts by avoiding non-enforcing courts. They can do this not only by avoiding contacts with non-enforcing jurisdictions, as discussed above, but also by contracting for adjudication of their disputes by pro-enforcement courts or arbitrators. As with choice-of-law contracts, choice-of-forum and arbitration contracts help motivate courts to maximize the welfare of all contracting parties rather than just the party that makes the ex post litigation decision. Rules regarding the enforcement of choice of forum and arbitration agreements therefore are a potentially important part of the institutions supporting Austrian law market processes.

Choice-of-forum and arbitration contracts may seem to raise the same issues as choice-of-law contracts in that courts that do not want to enforce the latter also will not enforce the former. However, contracting for the forum adds two new dimensions to jurisdictional choice. First, some courts that are not willing to enforce law-choice contracts may be willing to enforce forum-choice contracts because the latter do not require the court to choose between two competing state policies.

Second, federal law enters the picture with respect to forum choice through the Federal Arbitration Act, which itself was a response to global trade competition. Arbitration has become a powerful mechanism for supporting jurisdictional choice and furthering the Austrian discovery process. However, pro-litigation and consumer groups are now lobbying to reduce the role of arbitration, particularly of consumer contracts. Regulation of arbitration should take account of arbitration's benefits in promoting the law market.

Federal preemption rules

A final institution for promoting jurisdictional choice is the judicial rules for deciding on the extent to which federal statutes preempt state law under the Supremacy Clause of the Constitution. When a federal statute conflicts with state law, as long as the statute is within Congress's constitutional power it is the supreme law of the land and takes precedence over state law. Congressional intent as to the existence of a conflict with state law is often ambiguous and courts have taken a variety of approaches to resolving the ambiguity.

An approach to determining the scope of preemption that resonates with Austrian market processes is to interpret the federal law in light of the overall goal of achieving efficient jurisdictional choice (O'Hara & Ribstein, 2011). Specifically, as long as the states offer efficient jurisdictional choice, the courts should presume against applying the federal statute to override state law. On the other hand, where the federal law provides for choice of state law, or where the state choice of law rule does not enable efficient jurisdictional choice, these would be circumstances favoring presuming in favor of preemption. These results are grounded in the reasonable assumption that the U.S. federal system is designed to enable efficient jurisdictional choice, and therefore that Congress should be presumed to be crafting its law consistent with this design.

Private law

Even given the potential for jurisdictional competition, the effects of this competition may be limited by public lawmakers' weak incentives to innovate. Private parties' production of laws may usefully supplement public lawmaking (Hadfield and Talley 2006). However, private lawmaking, like jurisdictional competition, requires appropriate legal institutions.

In this case the main institutional aid is giving private lawmakers greater property rights in law (Kobayashi & Ribstein 2011). Under current law, private lawmakers may not obtain patent or copyright protection for their creations that are embodied in law (Copyright Act §105). Nor can they contract for substitute contractual protection because of legal restrictions on law firm non-competition agreements. Without such property rights, private lawmaking may be confined to interest groups which would limit the availability of efficient forms. Conversely, additional intellectual property rights in law could enhance the development of an Austrian-style market for law.

SPECIFIC APPLICATIONS OF THE MARKET FOR LAW

This Part applies the above general principles to a few areas of the law that significantly affect innovation. The following discussion attempts to capture the range of applications in terms of the feasibility of applying law market principles. Such applications illustrate the myriad of ways in which changing the legal process can encourage innovation and entrepreneurship toward economic growth and prosperity.

Business associations

Efficient business structures are vital to innovation. For example, capital-intensive firms need outside investors. These investors want rules that balance the benefits of empowering managers to run the firm against the need to hold them accountable for their actions. Given the almost infinite combinations of rules that are possible in structuring the governance of a business association, the market for state law is especially important in designing efficient business structures. Since large firms can have owners in many states, each of which can exercise jurisdiction over suits regarding the firm’s governance, any market for corporate governance law would be infeasible in large firms unless firms could choose a single state’s law to control their governance. Also, in situations involving long-term contracts governing parties whose needs may change and involving litigation that may arise multiple times during the life of the firm, parties have strong reasons for choosing not only a particular law but also a particular jurisdiction with reliable courts, lawyers, and legislature.

These conditions justify the strong U.S. rule providing for enforcement of firms’ choice of the state law applicable to their governance contracts (O'Hara & Ribstein, 2009). Under the so-called “internal affairs doctrine,” the parties to a firm can organize in any state and have the rules of the state of organization apply to their firm’s internal organization regardless of where they live or where the firm is based. The internal affairs doctrine has facilitated the evolution of the corporation from the era of special chartering, when firms had to seek legislatures’ permission to form, to the adoption throughout the U.S. of general incorporation laws giving the parties full contractual freedom to decide on governance rules appropriately tailord to fit their specific needs (Ribstein and O'Hara 2008). Broad application of the internal affairs doctrine to small and unincorporated firms has facilitated efficient contracting for incentives and governance in these firms. This is significant for present purposes because small firms are an important source of innovation and growth.

These considerations support continued encouragement of the corporate law market not only by enforcement of the internal affairs doctrine at the state level, but also by limiting the effect of federal securities and tax laws that can constrain the state law market. A positive development along these lines was the promulgation of the "check the box" tax classification rules, which permitted small firms to choose their business form irrespective of their tax status as corporations or partnerships (Treas. Reg. § 301.7701-1-3 (2004)). On the other hand, the expansion of federal law into the details of corporate governance in both the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 significantly reduced the ability of the state market for law to experiment with governance provisions and discover the most efficient provisions. Such preemptive prevention of experimentation is not conducive to a system of legal competition allowing room for innovation and economic expansion.

Law firms

Law firms are an important exception to firms' general freedom to choose the appropriate state governance law. As part of their power to regulate the legal profession, states limit the types of business structures lawyers practicing in the state can use for the practice of law. Because these rules apply to all lawyers practicing in the state, lawyers may not choose to organize under the law of State A while practicing in State B. National law firms therefore must abide by the laws of all of the states in which they practice. This rule effectively requires the legal profession to function under uniform laws proposed by the American Bar Association. Uniformity, in turn, bars law practice from the competitive lawmaking process that has enabled the evolution of business associations discussed in the previous section.

The purported rationale for having a distinct choice of law rule for law practice is that states have a special need to regulate the legal profession. Even if this is true, however, it does not clearly justify regulating law firms' structure, as distinguished from lawyers' and law firms' conduct. Firms generally are free to choose their business structure to best facilitate their business operations, including the firms' compliance with applicable regulation of business practices. It is not clear why the same principle should not apply to law firms.

Law firm governance illustrates the significance of jurisdictional choice in encouraging entrepreneurship. The existing regulatory structure of the legal profession is controlled by factions that exercise power in the American Bar Association. These groups seek to limit competition with lawyers by those who do not pay the entrance fee of a license to practice law and by lawyers who do not play by the existing rules of the game. A simple business-association-type rule that allowed national law firms to choose their state of organization could have profound effects in enabling entrepreneurship in the legal profession.

The availability of a competitive market for law firm governance is particularly important now because of the pressures facing law practice. Law firms confront unprecedented challenges to their business model because, among other things, of changes in technology and increased global competition. Innovations in business structure facilitated by legal competition would enable the legal services business to better respond to these challenges (Ribstein, 2010a). This, in turn, would not only facilitate growth of the legal services industry but also provide incentives for the development of more efficient legal information and services that could support growth throughout the economy.

An important example of the need for innovation in law firm structure concerns the sale of equity shares in law firms to non-lawyers. In the U.S. only lawyers may own law firms (Model Rules of Professional Conduct Rule 5.4). This means that law firms, the largest of which are multi-billion-dollar operations, can obtain financing only from their lawyers and bank loans. This limitation effectively forces firms to operate hand-to-mouth, and can result in their swift unwinding under financial pressure. It also prevents law firms from financing new lines of business such as investments in the research and development of new legal technologies and from fully realizing potential synergies from combinations with non-lawyer professionals.

A competitive law market for law firm governance would promote the development of financing structures that would meet the special challenges of non-lawyer financing of law firms. Law firms need new structural rules that balance outside investors' demands for power to protect their investments against lawyers' need for sufficient control to assure clients and regulators that the firm will maintain professional standards. These structures raise new issues and the potential problems are unforeseeable. Effective solutions call for the same sort of discovery process as the competition for business association laws under the internal affairs doctrine.

While jurisdictional competition for law firm structures would encourage beneficial innovation, it is also necessary to preserve some role for efficient state regulation of law firm structure. These objectives could be accomplished through a default rule of enforcing interstate law firms' choice of state law subject to each state's power to enact laws regulating local lawyers (Ribstein 2001).

Internet law

The Internet can be a powerful medium for communicating and gathering information. Because websites place unique identifying numbers called "cookies" on the hard drives of consumers who browse the Internet, web operators can gather information from consumers who visit their sites. This enables the operators to know which pages consumers visit and how long they spend on each page and potentially to link this information with customer identifying information such as email addresses, passwords, and credit card numbers. This technology offers significant opportunities to reduce transaction costs and increase information. At the same time, it poses potential problems by enabling sellers to invade consumers' privacy.

Balancing these competing concerns raises issues as to what the applicable rules should be, whether they should be default or mandatory, whether it is enough to let consumers opt out of default rules, or whether consumers should have to opt into rules that enable sellers to invade their privacy. The answers to these questions depend to some extent on how individual consumers weigh privacy interests against the convenience of visiting websites that know their preferences. Different types of transactions and goods and different types of consumers may call for different rules.

Developing a competitive legal process would enable experimentation and discovery necessary to determine the mix of rules that would enable efficient innovation. Each firm could choose the set of rules that best fits its business model. The industry could innovate based on these secure and suitable legal platforms. At the same time, enabling jurisdictional choice would offset the political power of powerful industry incumbents.

A fully competitive legal process in this area entails enforcement of choice of law contracts. If each state can apply its law under general common law choice of law rules to transactions that are connected to the state (which connections states can determine through modern geographic filtering technologies), sellers might not know which law applies to any of their transactions and may have to comply with the strictest rule (Kobayashi and Ribstein 2002). This would discourage legal innovation and deny firms the secure legal platforms they need for growth.

The National Conference of Commissioners of Uniform State Laws attempted to achieve interstate enforcement of choice of law contracts by promulgating the Uniform Computer Information Transactions Act, section 109(d) of which would enforce a choice of law clause in electronic consumer sales unless the contract would vary a mandatory rule in the seller's state. Like the internal affairs doctrine applicable to business associations, the choice of law contract would be enforceable without regard to the seller's or transaction's relationship with the state whose law is selected in the transaction. This would free sellers to choose the law of any state. If there is a restrictive law in the seller's home state, the seller can avoid the restriction simply by relocating to another state. A similar rule could be applied to the "cookies" context.

Only two jurisdictions adopted the UCITA provision and several adopted "bomb shelter" provisions that explicitly invalidated choice of law clauses choosing UCITA-based laws. This leaves firms subject to more open-ended default choice of law rules. This result arguably indicates the futility of relying on the uniform lawmaking process to encourage the efficient evolution of state law. States rejected contractual choice of law that was tied to an objectionable uniform law. Contractual choice might work if states were free to develop laws that met sister state objections rather than being bound to a single "uniform" solution.

The states' rejection of contractual choice in the internet setting also might reflect the states' inherent inability to coordinate on this issue, perhaps because local business interests are able to override those of out-of-state firms competing on the internet. The appropriate solution might be a federal law mandating enforcement of choice-of-law clauses, except to the extent enforcement is explicitly prohibited by a state statute. This could enable a competition among state laws which over time discovers the right balance between permissive and mandatory rules.

Non-competition clauses

Contracts restricting competition by former employees can significantly affect innovation. On the one hand, non-competition agreements protect employers' rights in intellectual property and thereby potentially encourage investments in creating that property and therefore innovation. On the other hand, non-competition agreements can inhibit the movement of knowledge, skills, and information among firms and thereby discourage innovation that depends on new combinations of these resources. Individual firms may be tempted to ignore the effect of their contracts on innovation because they incur all of the costs of losing control over intellectual property while capturing only some of the benefits of innovation. Such experimentation and competition is precisely what Austrians like Schumpeter emphasize as critical to a flourishing economy.

The problem of determining the appropriate regulatory approach to non-competition agreements illustrates how the law market can promote innovation while allowing space for reasonable regulation. The dynamic and long-term social costs and benefits of rules protecting property rights or encouraging the spread of knowledge are beyond the knowledge or foresight of any individual lawmaker. Indeed, it is likely that no single rule is appropriate. California's law making these clauses unenforceable has been heralded as spurring the growth of Silicon Valley (Gilson 1999). On the other hand, non-competes may be critical in industries in which developments take longer and patents and copyrights are less available to protect intellectual property. The law market provides a way to experiment with a variety of regimes to achieve the optimal pro-growth/pro-innovation policy.

Insurance

The insurance industry would seem to be ripe for innovation of numerous kinds of contracts that protect from a variety of risks. However, the industry is particularly stymied by the choice of law problem. The McCarran-Ferguson Act of 1945 prohibits federal regulation of the insurance business, thus leaving regulation up to the states. The states, for their part, are particularly reluctant to cede their regulatory power through enforcement of choice-of-law contracts, given concerns about the complexity and take-it-or-leave-it nature of insurance contracts and consumers' inability to judge insurers' solvency. Moreover, many states prohibit arbitration clauses in insurance contracts, thereby blocking an important mechanism for promoting enforcement of choice-of-law and choice-of-forum clauses.

There is currently a move toward repealing McCarran-Ferguson and federalizing insurance law. This would protect insurers from duplicative state regulation and consumers from inadequate state regulation. However, as discussed throughout this chapter, federal regulation would eliminate the potential for experimentation and discovery of superior regulatory solutions through state competition. Dodd-Frank made a move toward federalization but stopped with the creation of some oversight through a new Federal Insurance Office.

As with the other contexts discussed above, the various relevant interests could be addressed through a federal law that requires state courts to enforce choice-of-law provisions in insurance contracts unless a statute in the state where the policy is sold explicitly bars such enforcement (Butler and Ribstein 2008). This would enable firms to choose the law that suits their business and encourage states to adopt the laws firms prefer. States could compete to lead the competition, which is significant in this area given the complexity of insurance law and the need for regulatory expertise. States' ability to specialize may increase the quality of regulation compared to the current system of regulation under which parties cannot choose the applicable law. Also, states' power to adopt legislation applying local law to local insureds would help prevent a "race-to-the-bottom" in insurance law. At the same time, repealing McCarran-Ferguson and paving the way for potential federal regulation would discipline the states by exposing them to the threat that excessive regulation could lead to broad federalization of insurance law.

Property law

Rights concerning real property, including rules regarding use, ownership and transfer of the property, are subject only to the law of the state where the property is located. This clear "situs" rule at least reduces the potential for applying multiple state laws at the time of litigation to a single transaction. However, the application of a single rule also prevents the operation of a competitive process that can lead to the discovery of the most efficient menu of rules. As land use is subject to increasing stresses of laws relating to such matters as the environment, historic preservation and restrictions on growth (Garnett), there is a special need for a discovery process with respect to the development of new legal technologies for real property. (Morriss 2010, 116) A competitive law process could further this development by making it easier for property owners to choose among rights available in various states (O'Hara and Ribstein 2009, Chapter 8).

Conservation easements illustrate how such a law-making process could facilitate property rights innovations (Ribstein, 2010b). These instruments enable property owners to lock in particular uses of their property in perpetuity. Many states have adopted laws providing for these easements, spurred by a federal tax break for conservation easements. The complexity and novelty of these property rights and the federal tax law have induced states to widely adopt the Uniform Conservation Easement Act. Letting property owners enter into easements provided for by the law of states other than where the property is located could spur a competitive lawmaking process and legal innovations. As with the other areas discussed above, states would retain the ability to legislatively block local property owners from adopting certain types of laws. This combination of competition and mandatory rules could lead to the discovery of more efficient rules regarding this relatively new property right.

Products liability

Nowhere is there a greater need for legal process to pave the way for innovation than with regard to products liability law. Manufacturers may be significantly discouraged from innovating because new products pose new risks of liability to consumers for product injuries. The expansion of tort law is sometimes viewed as a failure of state law that calls for federal safety regulation to preempt the states. But before sacrificing the benefits of the market for state law, it is worth trying the choice-of-law alternative.

Current choice of law rules generally let plaintiffs choose to litigate in states with the most pro-plaintiff laws. Changing the prevailing rule to one that always applies the law where the product is manufactured could be too favorable to manufacturers. Applying the law of the state where the product is first sold might be a reasonable compromise because firms could determine their prices based on the product liability laws in each state where the product is sold. However, no states apply such a rule.

A possible solution, as with the other areas discussed above, is a federal law enabling the parties to contract for the applicable state's product liability law. Consumer groups might fear that this would cause a "race to the bottom" toward the laxest standards because consumers could be expected to shop on the basis of the applicable state law. However, states would have an interest in protecting their own residents from unsafe products rather than just being states chosen in product liability contracts. Also, manufacturers of high-quality goods have an incentive to avoid choosing very lax laws because of the negative signal this could send as to product quality. Consumers can rely on the press, blogs and consumer watchdogs to alert the market of very pro-manufacturer state laws and the large consumer product firms that adopt them.

Even if consumers cannot rely fully on the market, the system applied throughout this chapter – that is, enabling states to enact statutes blocking enforcement of contractual choice – could provide fallback protection. States could decide whether they want to adopt relatively lax product standards and enforce contractual choice in order to attract manufacturers into the state or adopt strict laws that protect consumers. The federal government could provide discipline by standing ready to supplant state law if states prove too obedient to trial lawyers or manufacturers. Conversely, courts could interpret federal laws narrowly to avoid preemption of state laws that enable efficient jurisdictional choice.

This approach would enable states to experiment with various legal rules and to discover policies that optimally balance the costs and benefits of product innovation. Although this system may not yield perfect results, it is important to keep in mind the costs of the alternatives – a chaotic state system that exposes manufacturers to the rules of all of the states in which they sell products, or a one-size-fits-all federal rule that preempts state law and precludes experimentation.

Franchise regulation

Franchising is a potentially valuable form of contracting and an important pathway for innovations in distributing products and services. However, state regulation has limited the usefulness of franchising by restricting franchisors' ability to terminate franchisees, thereby undercutting franchisors' most important mechanism of policing franchisees' attempts to cheat on quality. Proponents of the regulation argue that the laws are necessary to prevent franchisors from opportunistically using termination provisions to take over the locations that prove most profitable (i.e., "cream-skimming").

State franchise regulation has been tested in the market for state law. Franchisors have struck back against the regulation by inserting choice-of-law and choice-of-forum clauses in their contracts that avoid the most onerous state regulation. Regulating states counter-attacked by enacting laws invalidating these provisions. Theory predicts that franchisors would then avoid the states that insist on applying the most onerous laws. This, in turn, could set off a political backlash by workers, suppliers and customers in the state who are injured by the departure of the franchises.

Indeed, there is direct evidence of the reduction of outlets in regulating states, and indirect evidence of this reduction based on reduced employment in franchise industries. These effects are greatest in states that invalidate choice-of-law and choice-of-forum contracts (Klick, Kobayashi, and Ribstein 2006, 2009). These data indicate that the market for state law can enable innovation by limiting the effect of regulation.

Our proposed federal law mandating enforcement of choice-of-law clauses subject to states being free to opt out through legislation again provides a useful compromise between the market for law and state regulatory interests. This approach is particularly valuable in a context such as franchise regulation where the interest groups that would face off in the legislature are closely matched and the threat of franchisor exit could influence the legislative decision. As discussed in the article footnoted above, franchise regulation went through a period of back-and-forth between judicial decisions and legislation that left the law unclear and muted interest group competition. A clear rule providing for enforcement of choice of law clauses subject to state legislative opt-out could have shortened the period of uncertainty, helped ensure a regulatory outcome that best reflected all political interests, and encouraged growth-enhancing developments in franchising.

CONCLUSION

Austrian economics stresses the importance of market processes continually discover valuable information and entrepreneurship that discovers new and more efficient ways of doing business. Markets can be as important to the development of efficient legal frameworks as they are to business. Markets in both areas require the support of legal institutions. This Chapter suggests how the market for state law could be designed to produce a process for discovering efficient rules. Even if the suggested approach is not adopted, the main lesson of this chapter is that any regime for encouraging growth must take account of the existence of multiple jurisdictions and the potential for jurisdictional choice and competition.

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