LEGAL PROCESS AND THE DISCOVERY OF BETTER POLICIES FOR FOSTERING INNOVATION AND GROWTH

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ABSTRACT

Our chapter concerns how legal process can lead to efficient policies for fostering innovation and growth. Future innovation will depend at least as much on how laws are made as on a priori analyses of the optimal content of those laws. Of particular importance is whether U.S. choice of law and choice of forum rules promote an efficient market for law. Our analysis supports three suggestions for improving the law to support growth. First, the rules governing the selection of the jurisdiction whose law governs productive activity can significantly affect growth and innovation. Second, any proposal aimed at increasing growth through a change in law or legal institutions should take account of the existence of multiple jurisdictions and parties' ability to choose the jurisdiction whose law controls their transactions. Third, 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. We apply this analysis to several areas of the law that are critical to growth and innovation: non-competition clauses, business associations, the legal profession, internet law, insurance, property law, products liability, and franchise regulation.

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Our topic concerns how legal process can lead to efficient policies for fostering innovation and growth. Future innovation will depend at least as much on how laws are made as on a priori analyses of the optimal content of those laws. Of particular importance, as we discuss in this chapter, is whether the U.S. legal system promotes an efficient market for law.

Our analysis supports three suggestions for improving the law to support growth. First, the rules governing the selection of the jurisdiction whose law governs productive activity can significantly affect growth and innovation. Second, any proposal aimed at increasing growth through a change in law or legal institutions should take account of the existence of multiple jurisdictions and parties' ability to choose the jurisdiction whose law controls their transactions. Third, 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.

Linking Law Market Process with Innovation and Growth: The Information Problem in Institutional Design

Our analysis begins with Frederick von Hayek's insight in his famous article on the "The Use of Knowledge in Society"(Hayek 1945) that experts, academics, and lawmakers lack the necessary knowledge to make decisions about which legal and regulatory structures maximize welfare. 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 process the necessary information. Consistent with this approach, consideration of how to alter laws and regulations to increase innovation and economic growth must include an analysis of how to

harness market-like mechanisms to create an information network that leads to the discovery of better policies over time.

To understand the scope of the information problem involved in regulatory design, consider the broad array of potential legal rules governing contracts – mandatory vs. default rules, opt-in vs. opt-out, disclosure vs. substantive duties. In general, legal rules must be designed to solve specific problems in the market while permitting parties to engage in value-increasing transactions. These rules sometimes should restrict opportunistic conduct in order to encourage trade or investment, while at other times they should enable the parties to craft their own agreements. It is also necessary to promulgate legal rules that reduce information costs or transactional frictions or increase property rights. Individual policymakers, however, lack the knowledge or foresight to see all the potential alternatives or figure out which should be adopted. 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.

In order to solve the knowledge problem and create efficient legal technologies the lawmaking process should encourage innovation in the creation of legal rules. It is logical to use the same competitive process that encourages innovation in the private sector – that is, competition among suppliers – subject to rules and institutions regulating this competition. As we will see, this entails enforcing contracts among the parties regarding the applicable law (O'Hara and Ribstein 2009).

Jurisdictional choice and competition is particularly important to establishing a legal regime that promotes growth. First, the Hayekian "knowledge problem" is particularly challenging with respect to the rules appropriate to encouraging growth. There is much more

certainty and information about the rules likely to maximize wealth over the short term than about those that maximize wealth over time. For example, even if intellectual property rights clearly promote innovation now, the effects of locking up ownership rights in those innovations for long periods may be less clear. The greater the knowledge problem the more necessary it is to unleash markets to solve the problem.

Second, encouraging growth necessitates supplementing the "voice" of the political process with the power of exit, drawing from Albert O. Hirschman's famous analysis(Hirschman 1970). The political process inherently favors the interests of today's economically powerful firms over the small and not-yet-existing 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 market share. It is difficult to give future firms more voice without significantly altering the political system. However, these firms can influence policymaking by deciding where to locate their businesses. More specifically, 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. This process translates exit into political voice.

Critics of our approach may stress the imperfections of jurisdictional competition. Instead of racing to the top and enacting more efficient pro-growth laws, states may race to the "bottom" and enact laws that favor particular parties. 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. This could simply replace the defects of political choice with a different set of defects associated with exit. On the other hand, as discussed below, if states can override these contracts, the applicable state law effectively could be determined by plaintiffs' trial lawyers' decisions where to sue. This could introduce different but equally perverse legislative incentives. More jurisdictional choice also could mean more confusion and regulatory overlap.

One response to these criticisms is that a system that favors the dynamic growth potential of the firms empowered by greater jurisdictional choice necessarily increases social welfare compared to a system that focuses on avoiding static inefficiency caused by wealth-transferring regulation. To be sure, economically incumbent powerful firms could gain from greater ability to avoid regulating states. However, these firms already have a say in crafting regulation, and sometimes use this say to increase costs for potentially innovative competitors. Increasing the ability of innovative firms 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.

A stronger response is that criticism of jurisdictional choice must proceed against a background of inevitable jurisdictional choice and competition is in a multi-jurisdictional world. No single jurisdiction can reach all transactions in a global economy. Nor would we want it to since the result would be duplicative regulation and chaos. Economic actors therefore inevitably can choose the jurisdiction whose laws govern their transactions. The relevant question is how to establish the best possible system of jurisdictional choice for maximizing growth in a multi-jurisdictional system. Our proposal discussed in Part II and its application in the contexts discussed below tries to balance the benefits of exit and jurisdictional competition against the benefits of empowering governments to efficiently address local problems. In other words, what

system best channels jurisdictional competition toward efficient results? Criticism of our proposal should proceed against this backdrop of inevitable and necessarily imperfect jurisdictional competition.

Rule Changes That Could Boost Innovation and Growth through the Law Market

Regulating jurisdictional competition involves developing efficient rules regarding courts' choice of the law applicable to particular disputes, the role of federal law, and the development of alternative adjudication mechanisms. These are the "meta" or systemic changes we propose. We also examine applications to specific areas, and discuss the major pros and cons of each idea.

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. The courts apply vague rules whose application the parties cannot reliably determine prior to litigation. Courts often apply local law, which effectively lets whoever controls the litigation forum – usually the plaintiff – choose the law. Plaintiffs' lawyers 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.

By contrast, "ex ante" choice involves entering into a contract that chooses the governing law when the parties make their deal. Jurisdictions still would have an incentive to design their rules to encourage litigation. However, under this choice of law rule jurisdictions would attract litigation through rules that do not unfairly burden either plaintiffs or defendants generally.

Regardless of whether states do not change their laws in response to competition from other states (perhaps because they want to apply the laws to relatively immobile local parties) mobile firms would at least be able to be subject to the law of their choice wherever they choose to do business.

Changing choice of law rules to give greater recognition to the ex ante approach than is now the case could encourage innovation and growth. Rules that consider the interests of tort defendants as well as plaintiffs may constrain the development and liberalization of new causes of action that can inhibit technological innovation. Also, ex ante choice of law can encourage lawyers to develop new property rights and legal technologies by enabling the parties to ensure that the case is heard by a court that is likely to enforce the rights. For example, the choice of law rule which ensures application to business associations of the law of their formation states has been instrumental in encouraging the development of the limited liability company as well as arbitration and other informal methods of adjudicating business disputes.

Choice-of-law contracts might 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.

On the other hand, if courts do not enforce choice-of-law contracts they will apply default choice of law rules with the potentially perverse result discussed above that the choice is made by plaintiffs' lawyers. In other words, given multiple jurisdictions somebody must choose the applicable law and potential problems arise no matter who this is. Moreover, parties might react to a jurisdiction's non-enforcement of contractual choice of law by physically avoiding that

jurisdiction altogether. As discussed generally above concerning the effect of exit, this could activate exit-affected interest groups in the state and motivate the state to change its policy.

Regardless of whether enforcement of choice of law contracts is efficient, states have the constitutional *power* to block erosion of their regulatory authority through choice of law, and trial lawyers and other interest groups inevitably influence how this power is exercised. Accordingly, it is necessary to find some mechanism for deciding to what extent individual states may regulate or impose liability on multistate firms and or transactions that touch several jurisdictions.

Federal Substantive Regulation

The most obvious approach to resolving the above problems with state law might seem to be to apply federal law and thereby eliminate both the chaos of regulation by multiple states and the potential for a race to the bottom. But federal statutes inhibit the potential for state law competition and discovery.

Federal statutes are not necessarily wholly inimical to Hayekian processes. Even after Congress passes a federal law, courts must interpret the statute. Some types of statutory provisions provide a broad scope for legal evolution through a sort of common law process that performs some market-type discovery functions. Statutes can be designed with this process in view(Hylton 2003).

However, even the best-designed federal statute may allow for less Hayekian discovery and may be less conducive to growth than state law dealing with the same subject. The evolution of common law under federal statutes does not entail the sort of competition among multiple jurisdictions that can occur under an efficient state law system. Moreover, even a federal law

designed to enable evolution may involve the anti-growth problem of protecting incumbent firms. Moreover, 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 in the next section.

Federal Choice of Law Statutes

Instead of providing for specific regulation, federal law can promote Hayekian discovery 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.

Second, because legislation tends to be more transparent than judicial decisions, requiring restrictions to be embodied 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.

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.

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, 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.

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 Hayekian 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.

State Initiatives

Federal 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.

A Delaware court rule (Delaware Chancery Court Rules 96-98 (February 1, 2010)) indicates the potential for process innovation by the states. 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 process 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.

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.

Restricted Choice of Law: Non-competition Clauses

Contracts restricting competition by former employees can significantly affect innovation and growth. 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 between 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.

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.

Full Enforcement of Contracts: 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 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 long-term contracts where parties' needs may change and litigation may arise multiple times during the life of the firm, parties have strong reasons for choosing not only a particular law, but 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 (Ribstein, The Rise of the Uncorporation 2010). 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 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 applicable governance rules (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.

Innovation in the Legal Profession

Law firms are an important exception to firms' general freedom to choose the 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.

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, The Death of Big Law 2010). This, in turn, would not only facilitate growth of the legal services industry but 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 research and the 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 Hayekian discovery process as the competition for business association laws under the internal affairs doctrine. At the same time, it is 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, Ethical Rules, Law Firm Structure and Choice of Law 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 grow and innovate based on these secure and suitable legal platforms.

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 discovers the right balance between permissive and mandatory rules.

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, this volume), 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, The Market for Conservation Law 2010). 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 Litigation

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. The press, blogs and consumer watchdogs could be counted on 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.

This approach would enable states to experiment with various legal rules and 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 state 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, encouraged growth-enhancing developments in franchising, and helped ensure a regulatory outcome that best reflected all political interests.

Conclusion

Innovation and growth depend on the existence of a legal environment that allows room for these developments to occur. At the same time, society demands reasonable regulation even if this regulation could have the effect of inhibiting some innovation and growth. Individual lawmakers lack the necessary knowledge to determine just where to draw the line. This supports the need for a market-type legal process that enables discovery of optimal rules. This Chapter suggests how the market for state law could be designed to produce such a process. 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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