EVOLUTION OF LAW: INTERPLAY BETWEEN PRIVATE AND PUBLIC RULE-MAKING – A NEW INSTITUTIONAL ECONOMICS-ANALYSIS

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Abstract

Whereas the New Institutional Economics (NIE) is interested in the process of institution-building and the evolution of institutions, legal scholars study law-making processes and their variations. The evolution of institutions and law-making are thus overlapping, but not identical, processes. This paper focuses on analysing a certain aspect of the evolution of law, namely the interplay between private and public law-making processes. The article aims to introduce some basic ideas and concepts regarding the complex interplay between private and public rule-making as part of the process of the evolution of law, albeit from a NIE-perspective. It is argued that constitutional economics is a normative concept that has the capacity to provide a better understanding of the interplay between private and public rule-making.

Keywords: Private rule-making; public rule-making; evolution of law

1 Introduction

Whereas the New Institutional Economics (NIE) is interested in the process of institution-building and evolution of institutions,[1] legal scholars study the law-making processes and their variations.[2] The evolution of institutions and law-making are overlapping, but not identical, processes. Law-making – or the evolution of law – may be understood as a specific mode of the evolution of institutions, in so far as legal rules may be defined as 'institutions'.

This paper focuses on analysing a certain aspect of the evolution of law, namely the interplay between private rule-making and public rule-making processes. This aspect of rule-making will be analysed by applying the methodological instruments of New Institutional Economics. Parallel legal research in general, and especially in public international law[3] (as interesting as it may be), will not be discussed here.

Whereas the interface between private rule-making and public rule-making – i.e. 'hybrid rule-making' – has been studied in a constitutional economics perspective by

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[1] M. Eckhardt, 'Institutionen- und evolutionsökonomische Erklärungen des Rechtswandels', in W. Kerber (ed.), *Studien zur evolutorischen Ökonomik* (2004), at 165-200; T. Eger and P. Weise, 'Die Evolution von Normen aus Unordnung. Ein synergetisches Modell', in P. de Gijiesel (eds.), *Ökonomie und Gesellschaft, Jahrbuch 11. Markt Macht und Moral* (2000), at 192-209; H. Geue, *Evolutionäre Institutionenökonomik* (1997); M. Erlei, M. Leschke and D. Sauerland, *Neue Institutionenoekonomik* (2007), at 22; R. Richter and E.G. Furubotn, *Neue Institutionenoekonomik* (2011), at 7; V. Vanberg, 'Rational Choice, Rule-Following and Institutions. An Evolutionary Perspective', in U. Maeki, B. Gustafsson/C. Knudsen (eds.), *Rationality, Institutions and Economic Methodology* (1993), at 171-200.

[2] G. Bachmann, 'Privatrecht als Organisationsrecht. Grundlinien einer Theorie privateRechtsetzung', in J.J. Zivilrechtswissenschaftler, *Die Privatisierung des Privatrechts rechtliche Gestaltung ohne staatlichen Zwang* (2003), at 1-21; F. Kirchhof, *Private Rechtsetzung* (1987); C. Kirchner '§ 5 Die oekonomische Theorie', in K. Riesenhuber (ed.), *Europaeische Methodenlehre* (2010), at 134-158; S. Okruch, 'Der Wandel von Rechtsnormen in evolutorischer Perspektive', in G. Wegner and J. Wieland (eds.), *Formelle und Informelle Institutionen: Genese, Interaktionen und Wandel* (1998), at 101-151; S. Okruch, *Innovation und Diffusion von Normen* (1999); G.F. Schuppert, 'Das Konzpet der regulierten Selbstregulierung als Bestandteil eines als Regelungswissenschaft verstandenen Rechtswissenschaft', 4 *Die Verwaltung*, at 201-252 (2001).

[3] C. Kirchner, 'The Power of Rational Choice Methodology in Guiding the Analysis and the Design of Public International Law Institutions', 1 *Illinois Law Review* (Symposium Issue on International Law and Economics), at 419-428 (2008).

Kirchner and Schmidt,[4] the interplay between both types of rule-making has not been systematically analysed in the realm of New Institutional Economics.

This analysis aims to introduce some basic ideas and concepts regarding the interplay between private and public rule-making as part of the process of the evolution of law from the NIE-perspective. The discussion will begin by distinguishing between the different types of rules, and will proceed by introducing the methodological instruments that will be applied. This will be followed by a brief examination of the specific features of public and private rule-making, which will lay the foundation for a concluding analysis of the more complex interplay between the two rule-making processes.

2 Different Types of Rules

In NIE, *institutions* can be understood as formal or informal rules, or sets of rules, together with their enforcement mechanisms.[5] Legal rules, or sets of legal rules, together with their enforcement mechanisms, can thus be defined as institutions. Legal rules without enforcement mechanisms do not qualify as institutions.

From a NIE-perspective, the *evolution of law* is not synonymous with the *evolution of institutions*. This analysis focuses on the evolution of legal rules, which are effectively enforced. Rules which are not enforced or cannot be enforced are, in most cases, not relevant in the world of economics because they do not provide sanctions and incentives. They may, nevertheless, come into play if individuals are willing to follow such non-enforceable rules for reasons other than sanctions and incentives. Such rules may carry certain values which are internalised by the addressees of such rules. However, such phenomena are normally outside the realm of institutional economics today. They may become a subject matter of the discipline when behavioural economics is in a position to provide better insight into the interplay between external incentive mechanisms and internal value-driven incentives. The present research on fairness is leading in this direction.[6]

The distinction between formal and informal rules, as introduced by NIE-scholars,[7] is relevant for this analysis insofar as the process of creating informal rules may lead to rule-making. This might be an interesting topic with regard to the theory of rule-making; however, this topic is outside the interplay between private and public rule-making. The study of private rule-making starts with the process of formulating private-ordering rules and providing enforcement mechanisms for such rules. This rule-making process often starts with formalising existing informal rules. The analysis of this process of formalisation would exceed the scope of this paper.

The distinction between formal and informal rules in NIE corresponds to the distinction between legal rules on the one side, and custom and usage on the other side of legal theory.[8] In practice, however, it is not easy to draw the line between these two types of rules. One traditional test is to ask the question whether law courts incorporate customs and usages into *customary law*. Whereas the production of customary law is

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4 C. Kirchner and M. Schmidt, 'Private Law-Making: IFRS – Problems of Hybrid Standard Setting', in P. Nobel (ed.), *International Standards and the Law* (2005), at 67-82; C. Kirchner and M. Schmidt, 'Hybride Regelsetzung im Recht der Unternehmensrechnungslegung – Fehlentwicklungen im europäischen Gemeinschaftsrecht', 58 *Betriebswirtschaftliche Forschung und Praxis* 4, at 387-407 (2006).

5 E.G. Furubotn and R. Richter, *Institutions and Economic Theory* (2005), at 7; referring to G. von Schmoller, *Grundriss der Allgemeinen Volkswirtschaftslehre* (1900), at 61; see also: Richter and Furubotn, above n. 1, at 7.

6 E. Fehr and K. Schmidt, 'A Theory of Fairness, Competition and Cooperation', 114 *Quarterly Journal of Economics* 3, at 817-868 (1999); E. Fehr and K. Schmidt, 'Fairness, Incentives and Contractual Choices', 44 *European Economic Review* 4-6, at 1057-1068 (2000).

7 Erlei, Leschke and Sauerland, above n. 1, at 22; Furubotn and Richter, above n. 5, at 7; Richter and Furubotn, above n. 1, at 7, 8; S. Voigt *Institutionenoekonomik* (2009), at 20.

8 Custom does not, as such, constitute customary law without consent of a legally binding character to such a custom: B. Rüthers, C. Fischer and A. Birk, *Rechtstheorie mit Juristischer Methodenlehre* (2011), at 147.

an act of public rule-making, the development of customs and usages may (but not necessarily) lead to private rule-making. Thus, the creation of private rule-making via customs and usages is also outside the scope of this study.

Conventional legal definitions of *legal rules* often exclude formal rules created by private standard setters or rule-making bodies (private rules or standards; *privat gesetztes Recht*).[9] From an economics perspective, this very narrow definition of *legal rules* is not suitable for expounding the meaning of the *evolution of law*. Excluding private rules and standards would cause severe difficulties in understanding modern legal systems, which may be seen as a mix between rules produced by legislators and courts (public ordering), on the one hand, and private rules and standards on the other (private ordering).[10] A narrow definition of *legal rules* would automatically focus the attention of the analysis on the process of transforming private non-legal rules into legal rules. Incorporating international financial reporting standards (IAS and IFSR) into European Union law by the endorsement mechanism provided for in the IAS-Regulation is an example of such a transformation process. This phenomenon has been studied in the context of hybrid rule-making.[11]

For the purpose of this analysis, it makes sense to focus both on public rule-making (by legislative bodies and courts) and on private rule-making (by private organisations, standard setters and private contracting parties). These two modes of rule-making are characterised by different concepts of legitimisation. Whereas with public rule-making in democratic states, the source of legitimisation of law is acceptance of the rules of rule-making by the addressees of such rules, in private rule making, it is the consent of the rule-making private actors which legitimises such rules. As a consequence of this distinction, outsiders, although affected by such rules, are not part of the underlying consent and cannot be bound by such rules of private rule-making. One could reformulate this statement as follows: external effects of rules of private rule-making are not legitimised.

3 Methodological Issues

In order to study issues of evolution of legal rules and norms, one may look at various approaches of evolutionary economics.[12] An approach based on the methodology of NIE offers the advantage of having the possibility to start with the basic assumptions of the New Institutional Economics and then to introduce the necessary elements for studying the evolution of institutions step by step. The starting points are the assumptions of scarce resources and methodological individualism.[13] If individual actors have to make decisions on how to allocate scarce resources, it makes sense to add another assumption, that of self-interested rational behaviour. The actors may develop different strategies to overcome or at least to mitigate that scarcity of resources. In a world with division of labour, they have to co-ordinate their decisions and the decisions of other actors with whom they are interacting. Co-ordination of decisions might be improved if the interacting actors agree on enforceable rules which are binding on all of them. Rule-making thus appears to constitute a strategy to overcome or to mitigate scarcity of resources. Rule-making actors are confronted with two problems: (1) incomplete

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9 See Bachmann, above n. 2; Kirchhof, above n. 2; C. Kirchner, 'Regulierung durch Unternehmens-fuehrungskodizes (Codes of Corporate Governance)', 45 *Zeitschrift für betriebswirtschaftliche Forschung*, at 93-120 (2002).

10 For the term *private ordering* see: O.E. Williamson, 'The Lens of Contract: Private Ordering', 92 *American Economic Review* 1, at 438-443 (2002); for private ordering as a mode of cartelisation see: H. Kronstein, *Das Recht der internationalen Kartelle* (1967).

11 Kirchner and Schmidt (2005), above n. 4; Kirchner and Schmidt (2006), above n. 4.

12 F.A. von Hayek, *Der Wettbewerb als Entdeckungsverfahren* (1968); R.R. Nelson and S.G. Winter, *An Evolutionary Theory of Economic Change* (1982); D. North, *Institutions, Institutional Change and Economic Performance* (1990); and J.A. Schumpeter, *Theorie der wirtschaftlichen Entwicklung* (1911/1987).

13 K. Arrow, 'Methodological Individualism and Social Knowledge', 84 *American Economic Review* 2, at 3 (1994); C. Mantzavinos, *Individuals, Institutions, and Markets* (2001), at 3-7; and J.A. Schumpeter, *Das Wesen und der Hauptinhalt der theoretischen* (1908/1952).

information and (2) bounded rationality.[14] They are not in a position to engage in rule-making processes by simply defining certain goals and determining the ends to attain such goals (means and ends-paradigm).[15] A purely constructivist approach is deemed to fail.[16] But this insight does not necessarily lead to the conclusion that intentional rule-making is meaningless. It rather suggests that in the light of incomplete information and bounded rationality, intentional activities in the field of rule-making will have unintended side-effects. It becomes necessary to make new rule-making decisions in the light of non-satisfactory results. Rule making becomes a trial-and-error process in which the participating actors acquire information which is helpful in making better decisions. Rule-making processes thus may be designed as incomplete contracts in which specification of obligations of the contracting parties is postponed to a point in time when they have sufficient information to make the decisions.

The assumptions relating to scarcity of resources, methodological individualism, self-interested behaviour, incomplete information and bounded rationality support an understanding of rule-making as a learning process in which the participating actors make decisions as part of a search process. This concept of rule-making as a learning process relates to modern evolutionary economics,[17] in particular, the evolutionary concepts of competition.[18] It is therefore helpful to have a closer look into the specific features of different rule-making processes in order to understand the games of various actors participating in rule-making.

4 Public Rule-making

Public rule-making is different in civil law jurisdictions and in common law jurisdictions. In civil law jurisdictions, the legislator is the primary law-maker. According to the specific concept of the separation of powers, the judiciary is supposed to apply legislatory law, and is therefore the 'mouth of the legislature' (or the *pouvoir nul*).[19] Judge-made law is created under the guise of interpreting legislatory law. Precedents are not legally (although often factually) binding. In common law jurisdictions the concept of the separation of powers is different: in a system of checks and balances, two competing lawmakers exist – the legislator and the courts. Precedents are legally binding (the *stare decisis* doctrine).[20] Some authors argue that there remain few differences between judge-made law in civil law and in common law jurisdictions today; both jurisdictions are supposed to converge in this aspect.[21] But this line of argument overlooks the

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[14] R.B. Korobkin and T.S. Ulen, 'Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics', 88 *California Law Review* 4, at 1051-1144 (2000); and Mantzvinos, above n. 13, at 52.

[15] F.A. von Hayek, 'Economics and Knowledge', 4 *Economica* 13, at 33-54 (1937); and M. Streit, *Theorie der Wirtschaftspolitik* (2005), at 270; Kirchner, above n. 2, at 140-141.

[16] F.A. von Hayek, *Die Irrtuemer des Konstruktivismus* (1975).

[17] Mantzavinos, above n. 13, at 188-226; Vanberg, above n. 1; G. von Wangenheim, 'Evolutionary Economics', in D. C. Scott (ed.), *Encyclopedia of Law and Society, Vol. 1* (2007); U. Witt, *Individualistische Grundlagen der Evolutorischen Oekonomik* (1987); and U. Witt, 'Evolutionary Economics', in S.N. Durlauf and L.E. Blume, *The New Palgrave Dictionary of Economics, 2nd Edition, Vol. 3* (2008), at 67-73.

[18] Hayek (1968), above n. 12; W. Kerber, 'Innovation, Handlungsrechte und evolutionärer Marktprozeß', in U.Witt (ed.), *Studien zur evolutorischen Oekonomik II* (1992), at 171-195; W. Kerber, 'Evolutorischer Wettbewerb. Zu den theoretischen und institutionellen Grundlagen der Wettbewerbsordnung', (1994, unpublished thesis); and W. Kerber, 'Wettbewerb als Hypothesentest: Eine evolutorische Konzeption wissenschaftenden Wettbewerbs', in K. von Delhaes, U. Fehl and L. Balcerowicz (eds.), *Dimensionen des Wettbewerbs* (1997), at 27-29; Mantzavinos, above n. 13, at 188-226.

[19] C. Kirchner, 'The Difficult Reception of Law and Economics in Germany', 11 *International Review of Law and Economics* 3, at 277-292 (1991).

[20] *Stare decisis* translates as '*stare decisis et non quiete movere*' (to stand by that which is decided); Cornell University Law School, Legal Information Institute, source: <http://www.law.cornell.edu/> (Last visited 4 Dec. 2011).

[21] G. Hager, *Rechtsmethoden in Europa* (2009); and S. Vogenauer, *Die Auslegung von Gesetzen in England und auf dem Kontinent. Eine vergleichende Untersuchung der Rechtsprechung und ihrer historischen Grundlagen* (2001).

essential difference between legally binding and factually binding precedents.[22] From a New Institutional Economics' perspective, this difference is essential; it is more difficult to predict future judge-made law in civil law-jurisdictions using factually binding precedents than to make predictions under the *stare decisis* doctrine. However, this issue will not be discussed in detail here, since the evolution of law in common law jurisdictions will not be analysed in this paper. We shall instead focus on the evolution of law in civil law jurisdictions.

When studying the rule-making process in civil law jurisdictions, the analysis in most cases starts with a political decision, which either aims to deal with a new problem, or aims to improve existing solutions to existing problems. In a NIE-analysis of rule-making, it makes sense to understand legal rules and norms as 'hypothetical problem solutions'.[23] In modern civil law jurisdictions, the first step of the legislative rule-making process is, in most instances, preparatory work done by the administration, which then undergoes a process of modification by the legislative body. The problem of incomplete information for both actors participating in this rule-making process is that the result of this type of rule-making reflects the information available at the time of rule making. The hypothetical problem solution resulting from this process may be regarded as a hypothesis of how to deal with the politically defined problems. The underlying problem is that of the means-and-ends-paradigm. The problem solution may lead to unintended consequences for intentional activities.[24] Looking at the rule-making process from an evolutionary perspective, the question arises how to deal with such unintended consequences, taking into account that the rule-making capacities of the executive branch and the legislative branch are limited. If an unintended consequence arises, the reaction of the public *law-maker* is relatively slow. Thus, the judiciary steps in. Applying the method of finality (teleological interpretation), courts engage in correcting and modifying legal rules of legislative law.[25] The typical shortcomings of this type of judicial response (to the unintended consequences of legal rules of legislative law) are due to courts' lack of satisfactory knowledge of facts and theoretical approaches of social sciences. Courts in civil law jurisdictions focus on legal problems and tend to neglect problems related to information as problems of inadequate social science methodological instruments for conducting impact analyses of alternative problem solutions. In this instance, the legislator might step in, if such rule-making capacities are available. One comparative advantage of the legislator as compared to the judiciary in the role of law-maker is the ability of the legislator to look into problem solutions which have been developed in other jurisdictions. Courts often lack the capacity or the willingness to make use of comparative legal studies. This was different in the past, when courts were known to have cited foreign cases more openly.[26] However, even if the legislator does make use of this comparative method,[27] the problem of legal transplants is still relevant:[28] legal transplants do not necessarily lead to the same consequences in a different legal, social and economic environment.

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22 Ruethers, Fischer and Birk, above n. 8, at 154-155.

23 Kerber (1997), above n. 18.

24 See sources cited supra n. 15.

25 H-J. Koch and H. Ruessmann, *Juristische Begründungslehre* (1982), at 222-227; Ruethers, Fischer and Birk, above n. 8, at 474-480.

26 R. Zimmermann, 'Der europäische Charakter des englischen Rechts', 1 *Zeitschrift für Europaeisches Privatrecht*, at 4-50 (1993); R. Zimmermann, 'Historische Verbindungen zwischen civil law und common law', in P.C. Mueller-Graff (ed.), *Gemeinsames Privatrecht in der Europäischen Gemeinschaft* (1993), at 47-70; and R. Zimmermann, 'Roemisches Recht und europäische Rechtseinheit', in W. Ludwig (ed.), *Die Antike in der europaeischen Gegenwart, Veroeffentlichungen der Joachim Jungius Gesellschaft der Wissenschaften* (1993), at 151-169.

27 For the comparative method, see A. Schwartze, '§ 4 Die Rechtsvergleichung', in K. Riesenhuber (ed.), *Europaeische Methodenlehre* (2010), at 113-131.

28 J. von Hein, *Die Rezeption US-amerikanischen Gesellschaftsrechts in Deutschland* (2008), at 57; C. Kirchner, 'Comparative Law and Institutional Economics – Legal Transplants in Corporate Governance', in P. Nobel (ed.), *New Frontiers of Law and Economics, Series in Law and Economics*, *First International Scientific Conference on Law and Economics at the University of St. Gallen, October 27-28, 2005* (2006) at 201-214.

The process of public rule-making changes in a setting of legislatory competition.[29] If addressees of legal rules and norms are free to opt out of their national jurisdictions on the basis of party autonomy granted by conflict of law-rules, it might make sense for national legislators to react to competing products of other legislators. This reaction is no longer simply based on the legislators' interests in other problem solutions in other jurisdictions. If legislators want to stop 'their own' legal addressees from opting out of domestic law, they have to offer attractive legal rules.

From an evolutionary perspective, legislatory competition is important because rule-making may be regarded as a production process in competitive markets. Addressees of legal rules and norms are no longer the victims of domestic legislators and courts that monopolise law-making in the field of applicable law. They are emancipated and become market participants. The rule-making has to meet their quality expectations and their preferences. From an economic perspective, this means that decentralised information becomes relevant. Legal addressees might have a better insight into the expected consequences of applicable legal rules and norms compared to the information of legislators and courts, which enjoy a monopoly position. However, the monopoly position of the legislator should not be over-emphasised. The legislator is part of a governance structure distinct from that of the market. The democratic feedback process should serve to limit the power of the legislator. Despite this, deficiencies in public governance structures reduce the power of citizens as principals and provide discretionary power for legislators. Thus, legislatory competition improves the position of the addressees of legal rules and norms: it adds *exit* to *voice*.[30] Because of this exit option, legislators have to take into account the quality standard preferences of the addressees of legal rules and norms.

Even if legislatory competition improves the process of public rule-making, a caveat should be considered, namely that of legal transplants (as mentioned above). A public law-maker cannot easily copy problem solutions of competing legislators. One further caveat to be added: the addressees of legal rules and norms are not solely affected by the products of the legislator. If they opt for another legal regime, they are buying not only into legislative law, but also into judge-made law, which has been produced by interpreting legislative legal rules and norms.[31]

5 Private Rule-making

5.1 Types of Private Rule-making

As has been previously mentioned, there are different types of private law making. We shall focus on three types which appear to be especially important: (1) private standard-setting, (2) private codes of conduct, and (3) private contracting.

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[29] E. Carbonara and F. Parisi,'Bargaining for Legal Harmonization: Jurisdictional Competition and Legal Obsolescence', in T. Eger et al. (eds.), *Internationalization of the Law and its Economic Analysis* (2008), at 339-352; K. Heine *Regulierungswettbewerb im Gesellschaftsrecht. Zur Funktionsfaehigkeit eines Wettbewerbs der Rechtsordnungen im europäischen Gesellschaftsrecht* (2003); K. Heine and W. Kerber, 'European Corporate Laws, Regulatory Competition and Path Dependence', 13 *European Journal of Law and Economics* 1, at 47-71 (2002); W. Kerber, 'Interjurisdictional competition within the European Union', 23 *Fordam International Law Journal*, at 216-249 (2000); C. Kirchner, R. Painter and W. Kaal, 'Regulatory Competition in EU Corporate Law after *Inspire Art*: Unbundling Delaware's Product for Europe', 2 *European Company and Financial Law Review* 2, at 160-171 (2005); H. Merkt, 'Das Europaeische Gesellschaftsrecht und die Idee des "Wettbewerbs der Gesetzgeber"', 59 *RabelsZ*, at 545-568 (1995); E. O-Hara and L. Ribstein, *The Law Market* (2009); and N. Reich,'Competition Between Legal Orders: A New Paradigm of Law?', 29 *Common Market Law Review*, at 861-896 (1992).

[30] On *exit* and *voice* see: A. Hirschman, *Exit, Voice and Loyalty. Responses to Decline in Firms, Organizations and States* (1970).

[31] Kirchner, Painter and Kaal, above n. 29.

5.1.1 Private Standard-setting

Private standard-setting has been the subject of numerous studies.[32] From a NIE-perspective, the crucial questions include how private standard-setting copes with the problem of incomplete information and how it deals with the problem of unintended side effects. Standard-setting by the International Accounting Standards Board (IASB) may serve as an example for this purpose. Standard-setting is based on a sequence of draft proposals, comments by interested parties and standard-setting decisions made by a standard-setting body. Because of the non-binding nature of such standards (at least in the absence of hybrid rule-making), the standard setter has to anticipate the willingness of future users of the standards to apply them. Thus, private standard-setting has some qualifications in a market process. But this depends to a large extent on the existence of competing standard setters. Cartelisation of standard setters may be understood as mitigating competitive pressure. In euphemistic terminology, cartelisation is called *harmonisation* or *agreement on world-wide standards*. Eliminating competitive pressure leads to a reduction of information in the standard-setting process. If competing standards exist, a comparative analysis can provide additional information on the expected outcome of proposed standards.

In the same way as public rule-making, private standard-setting *interpretations* of existing standards are a common mode of rule-making.[33] Such interpretations may be used to deal with unanticipated problems. The problem solution thus is similar – but not identical – to the production of judge-made law in public rule-making.

5.1.2 Private Codes of Conduct

Today, private codes of conduct are a common concept of private rule-making. Examples include take-over codes[34] and corporate governance codes.[35] An examination of the process of rule-making in the context of the German Corporate Governance Code[36] reveals some interesting features of an evolutionary rule-making process. The starting point of this rule-making process was the installation of a *government commission,* which was mandated to write a non-binding set of rules for corporate governance of German capital market-oriented corporations. The Code distinguishes between different types of provisions, ranging from quasi-binding provisions to recommendations. The provisions comprising the Code were not derived from actual practice of corporate governance in Germany (inductive approach), but were intended to constitute rules for *good governance* (deductive approach). What constitutes *good governance* is defined by the consent of the members of the government commission. Thus, in essence, the product is not purely private rule-making but rather looks like hybrid rule-making.

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[32] Bachmann, above n. 2; C. Kirchner, 'New Institutional Arrangements in International Economic Law: The Working of Codes of Conduct', in H.J. Vosgerau (ed.), *New Institutional Economics for the World Economy* (1989), at 409-435; Kirchner and Schmidt (2005), above n. 4; Kirchner and Schmidt (2006), above n. 4; M. Schmidt, 'On the Legitimacy of Accounting Standard Setting by Privately Organised Institutions in Germany and Europe', 54 *Schmalenbach Business Review*, at 171-193 (2002).

[33] See C. Kirchner, 'Zur Interpretation von internationalen Rechnungslegungsstandards: das Problem"hybrider Rechtsfortbildung"', in D. Schneider, D. Rueckle, H-U. Kuepper and F.W. Wagner (eds.), *Kritisches zu Rechnungslegung und Unternehmensbesteuerung. Festschrift zur Vollendung des 65. Lebensjahres von Theodor Siegel* (2005), at 201-217.

[34] C. Kirchner and U. Ehricke, 'Funktionsdefizite des Uebernahmekodex der Boersensach-verstaendigenkommission', 43 *Die Aktiengesellschaft*, at 105-116 (1998); C. Kirchner and M. Schmidt, 'Private Law-Making: IFRS – Problems of Hybrid Standard Setting', in P. Nobel (ed.) *International Standards and the Law* (2005), at 67-76; and E. Schanze, 'International Standards – Functions and Links to Law', in P. Nobel (ed.), *International Standards and the Law* (2005), at 83-103.

[35] Kirchner, above n. 9.

[36] German Corporate Governance Code, as amended on 26 May 2010: <http://www.corporate-governance-code.de/eng/download/kodex_2010/German-Corporate-Governance-Code-2010.pdf> (Last visited 5 Dec. 2011).

Acceptance of the provisions of the Code is measured annually.[37] If acceptance diminishes, there are two different problem solutions: (1) amendment of the provisions in question in order to improve acceptance, or (2) a request that the public law-maker promulgate enforceable legal provisions that are created within the governance structure of legislative law-making (see supra section 4 'public rule-making'), but which do not have to be accepted by legal addressees. In light of these two options, the learning process, by way of dialogue between the government commission and the addressees, is more or less comparable to that of public rule-making. The commission functions as a legislator, but without the legitimisation of a democratically elected legislator. The expectation that a quasi-private law-maker has better access to information, and is more flexible compared to a public law-maker, is therefore not met.

5.1.3 Private Contracting

Private parties engage in drafting and concluding contracts which extend beyond existing contracts. They not only invent new provisions and new types of contracts, but develop new forms of transactions and cooperation. Incomplete contracts are today not only a field of interest for legal practitioners and scholars, but increasingly for economists.[38] From our perspective of the evolution of law, incomplete contracts are a fascinating phenomenon. They cope with the problem of incomplete information by leaving open issues which can be better dealt with in the future in light of improved information. The learning process is built into the contract. However, the price is high: a contracting party that makes specific investments in such an incomplete contract may become the victim of a hold-up (i.e. of ex post-opportunism of the other contracting party). From an evolutionary perspective, this problem of ex post-opportunism leads to solutions according to which procedural rules and allocation of competences become more relevant than substantial rules. The awareness of incomplete information is an incentive to engage in rule-making of meta-rules for the contract. However, there are potential unintended consequences of promulgating such meta-rules: the contracting parties may lack sufficient information to promulgate effective meta-rules. Thus, incomplete contracts may be understood as drafting rules in a learning process for governing future transactions between the contracting parties. Procedural rules and rules on the allocation of competences are inherently incomplete. It is interesting to note that informal rules come into play at this point. They are especially important in Japanese contracts and serve as a device through which to mitigate the effects of ex post-opportunism.[39]

6 Interplay Between Private and Public Rule-making

6.1 Private Rule-making Endeavours as a Starting Point of Evolution of Law

Given the decentralised allocation of information, it makes sense to start with private rule-making. Let us begin with the problem of organising capital markets. Building a market platform – e.g. a stock exchange – requires rule-making in order to create market access. Financial reporting standards may be understood as safeguarding the quality of products that are traded on a market platform. Private actors have access to information which might be required in order to safeguard the quality of marketed

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[37] A. von Werder and J. Böhme, 'Corporate Governance Report 2011', in 64 *Der Betrieb* part I, at 1285-1290; part II, at 1345-1353 (2011).

[38] O. Hart and J. Moore, 'Foundations of Incomplete Contracts', 66 *Review of Economic Studies* 1, at 115-138 (1999); E. Schanze, 'Symbiotic Contracts: Exploring Long-Term Agency Structures between Contract and Corporation', in C. Joerges (ed.), *Franchising and the Law. Arbeiten zur Rechtsvergleichung, Vol. 153* (1991); E. Schanze, 'Symbiotic Arrangements', 149 *Journal of Institutional and Theoretical Economics (JITE)* 4, at 691-697 (1993); and Schanze, above n. 34.

[39] C.F. Goodman, *The Rule of Law in Japan* (2008), at 322; H-P. Marutschke, *Einfuehrung in das japanische Recht* (2010), at 10.

products. Financial reporting standards may thus be regarded as devices designed to reduce information asymmetries between sellers and buyers of financial instruments. The incentive for creating standards is to make the market platform attractive and thus more profitable. This is an incentive comparable to the incentive in a product market to create new products and to safeguard their quality.

When it comes to codes of conducts as examples of private rule-making, the argument in favour of private standard-setting might also be brought into play. Members of a private rule-making body might enjoy superior information compared to public law-makers. Furthermore, they may be in a better position to respond more quickly to new information. However, if the private rule-making body acts like a public rule-making body, such comparative advantages may be at risk of fading away.

In the field of private contracting, the comparative advantages of private rule-making vis-à-vis public rule-making are evident. Public law-makers do not have comparable access to necessary information.

Private rule-making in the various fields of law is the product of comparative advantage of private rule-makers over public rule-makers; private rule-makers have better access to necessary information. They are experts in the field of rule-making. Thus, they are able to react quickly to a changing environment.

6.2 Response of Public Rule-making

6.2.1 Preliminary Considerations

There are some general explanations why the public law-maker responds to private rule-making endeavours. The first explanation relates to a transaction cost consideration. If private law-makers have created different rules and norms, the public law-maker may step in and reduce transaction costs by offering either standardised default rules or standardised cogent rules. Both types of rules encompass different effects. In case of standardised cogent rules, the price for such standardisation and transaction cost reduction is a reduction of options. Phrased in legal terminology, *private autonomy* is curtailed. The learning process is affected considerably, thus counterbalancing the positive effects of transaction cost reduction. In the case of standardised default rules, private parties are free to decide whether or not to make use of the new legal rules. The parties themselves weigh effects from transaction cost reduction and effects from tailor-made rules on the basis of private law-making.

The second explanation concerns an externality argument. Private rule-making may create externalities for non-participating outsiders. Internalisation of such external effects by Coasean negotiations may not work in light of insurmountable transaction costs. The public law-maker then steps in and eliminates or internalises externalities. The aim is to better legitimise legal rules and norms. However, the price to be paid might be high: the learning process might be affected. And it is not certain that public rule-making creates new externalities, especially if private actors invest in lobbying.

6.2.2 Responses to Private Standard-setting

Private standard-setting may easily create externalities. This is a well-known phenomenon in competition law and is usually referred to as exclusionary effects.[40] Insiders may use their *standard-setting power* in order to systematically discriminate against factual or potential competitors. However, once again, it has to be taken into account that the public law-maker may further this discrimination under the influence of lobbying. This is especially true if private rule-making is substituted not by public rule-making, but by hybrid rule-making.

[40] I.e. the exclusionary effects of standardisation.

6.2.3 Responses to Private Codes of Conduct

As has been mentioned in the case of private codes of conduct, the public law-maker may transform provisions of private codes into statutory law. Two alternatives are given: (1) in case of overall acceptance of private code provisions, the public law-maker may step in and reduce transaction costs, and (2) in case of a lack of acceptance of private code provisions, the public law-maker may create binding statutory provisions. The latter case may be the result of lobbying of the private (or semi-private) rule-making body (e.g. a government commission). There may even be cases of collusion between the rule-making body and government officials in charge of appointing members of the commission in question.

6.2.4 Responses to Private Contracting

In case of private contracting, the response of public rule-making may be provided by the legislator or the judiciary. In most cases, courts will have to deal with the problems of private contracting if one of the parties takes legal action in a public law court. Court decisions will then define the limits of private rule-making by testing the compatibility of provisions of private contracting and binding statutory (or case) law. A possible response – or anticipated response – of private parties engaged in private contracting is the use of arbitration clauses.

The legislator may become active and create legislatory law in order to reduce transaction costs, but the price to be paid might be a slow-down of the learning process.

6.3 Responses of Private Rule-making Actors to Public Rule-makers' Responses

Private rule-making actors may respond to public law-makers' responses. The general explanation for this 'response to a response' is that private law-making actors are not convinced that the problem solutions provided by public law-makers are superior to their own. Rules of conflict of law come into play. Whereas the public law-maker is, in essence, confined to the national jurisdiction – where costs of supranational and/or international co-operation may be tremendous – private law-makers may act at the international level. This is especially the case in the field of private contracting – such contracts can be denationalised; private parties may conclude self-enforceable contracts. The national public law-maker may still engage in creating binding legal rules and norms. However, they can only bind private actors who are not able to opt out. In the field of legislatory competition, with respect to corporate law, it might be possible to opt out of national laws if private law-makers are able to write their own corporate law, include arbitration clauses and find a nation state which is willing to adopt that corporate law as national law.[41]

6.4 The Interplay Between Private and Public Rule-Makers as a Learning Process

The interplay between private and public rule-makers can be understood as a learning process. Decentralised knowledge is utilised by private rule-makers. They induce a learning process for the public rule-maker. However, public rule-making is confined to knowledge existing at the time of such rule-making. Private rule-makers are in a position to react quicker to new emerging decentralised knowledge compared to the public rule-maker. By forcing the public rule-maker to react, they again create incentives for a learning process for the public rule-maker.

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[41] Kirchner, Painter and Kaal, above n. 29, at 191-206.

6.5 The Interplay Between Private and Public Rule-Makers as a Legitimisation Process

The interplay between private and public rule-makers may be understood as a legitimisation process. Private rule-makers lacking legitimisation to create binding rules for outsiders produce externalities. Due to very high transaction costs, such externalities can be dealt with by a Coasean negotiation solution. Those actors, being affected by the externalities, may (and often will) ask the public rule-maker to intervene. If such intervention creates a pay-off for the actors participating in the public rule-making process – e.g. by getting more votes in public elections – the public rule-maker will step in and *protect* the victims. However, due to the comparative information advantage of the private rule-maker, there will be endeavours to circumvent public rules and to start the game again. The process is driven by the existing information asymmetry and incentives for both sides to promote their relative position.

7 Concluding Remarks

The evolution of law can be better understood if the interplay of private and public rule-making is taken into consideration. What is necessary is to develop a more stringent structure for this type of analysis and to arrive at normative conclusions. One normative concept which may be used is that of constitutional economics, which has previously been applied to hybrid rule-making.