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# Privatizing the Adjudication of International Commercial Disputes: The Relevance of Organizational Form

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# Privatizing the Adjudication of International Commercial Disputes:

## The Relevance of Organizational Form

Kevin E. Davis\*

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### Abstract

What role should for-profit organizations play in governing commercial transactions? Recent scholarship on the privatization of commercial law has advocated expanding the role of for-profits. This essay tests the merits of that proposal in a context where the case for relying on for-profits seem particularly strong, namely the adjudication of international commercial disputes. Both theory and evidence suggest that there is a role for providers of dispute resolution services that take a variety of organizational forms, including for-profits, not-for-profits, international organizations and various kinds of hybrid organizations.

### 1. Introduction

Should profit-maximizing private firms be responsible for governing commercial transactions? In recent years several commentators have argued that profit-oriented private actors (“for-profits”) ought to play a greater role in governing commercial transactions.<sup>1</sup> This presents a profound challenge to the conventional idea that law is a

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<sup>1</sup> Gillian K. Hadfield, *Privatizing Commercial Law*, *Regulation* 40 (2001) [hereinafter, *Privatizing Commercial Law*]; Gillian Hadfield and Eric Talley, [On Public versus Private Provision of Corporate Law](#), 22 *Journal of Law, Economics, & Organization* 414 (2006) [hereinafter, *On Public versus Private Provision of Corporation Law*]; Gillian Hadfield, *The Public and the Private in the Provision of Law for Global Transactions*, in Volkmar Gessner (ed.) *Contractual Certainty in International Trade: Empirical Studies and Theoretical Debates on Institutional Support for Global Economic Exchanges*, (Oxford: Hart Publishing 2009) [hereinafter, *The Public and the Private*]. For earlier treatments of this topic see William

quintessentially public good that ought to be provided by public actors and adds an important dimension to debates over who should govern the commercial transactions that sustain our economic life.

Advocates of privatization emphasize the superior – relative to public actors – incentives and resources of for-profits operating in competitive markets. This essay tests that claim by examining a setting in which the advantages of for-profits should be most pronounced, namely, the market for adjudication of international commercial disputes. Remarkably, for-profits do not dominate. The actors who adjudicate international commercial disputes include for-profits, not-for-profits, international organizations, publicly-sponsored courts, and hybrid organizations. The organizational diversity is striking.

Understanding that organizational diversity and its ramifications requires a new theoretical framework. To begin with, it requires a framework that goes beyond a simple public/private dichotomy and recognizes a range of organizational forms. It also requires acknowledgement of the fact that the ‘market’ for adjudication of international commercial disputes bears little resemblance to the kinds of perfectly competitive, undistorted externality-free markets whose virtues privatization advocates invoke.

The theoretical framework developed below takes these factors into account and shows that under certain conditions the incentives of and resources available to for-profits may be inferior to those of actors that adopt other organizational forms. At the same time, it shows that there is no reason to presume that the organization best suited to

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Landes and Richard Posner, Adjudication as a Private Good, 8 *Journal of Legal Studies* 235 (1979) and other contributions to the same volume as well as, Bruce L. Benson, The Spontaneous Evolution of Commercial Law, *Southern Economic Journal* 644 (1989). For a more recent and general treatment of private lawmaking see David V. Snyder, Private Lawmaking, 64 *Ohio State Law Journal* 371 (2003)

adjudicate any given dispute will be a publicly-sponsored court. Taking organizational form into account offers the possibility of new answers to questions about who should govern international commerce.

Section 2 of this essay lays out the case for relying on for-profits to help resolve international commercial disputes. Section 3 describes current practices and shows that for-profits actually play a limited role in adjudicating international commercial disputes. Section 4 examines the theoretical connections between organizational form on the one hand, and on the other hand, incentives of and resources available to organizations that provide international commercial dispute resolution services. This analysis both explains and justifies current practices. It also casts doubt on the merits of proposals to expand the role of for-profits in the adjudication of international commercial disputes. Section 5 concludes.

## 2. The case for for-profits

### *What is a for-profit organization?*

Economic actors can take a variety of organizational forms but the three main categories are: for-profit, not-for-profit, and public. For present purposes the for-profit category will be defined to include actors with private residual claimants, encompassing familiar organizational forms such as sole-proprietorships, corporations and partnerships. The not-for-profit category contains actors without residual claimants that are not controlled by the state. The public category consists of actors controlled by the state. These categories are neither comprehensive nor mutually exclusive. In other words,

hybrids, such as publicly-controlled for-profits, and alternatives, such as international organizations or private actors with limited residual claims, are possible.

*The case for for-profit production of commercial law*

In recent years the strongest proponent of having for-profits play a greater role in governing commercial transactions has been Professor Gillian Hadfield.<sup>2</sup> Her central argument seems to be that when it comes to the production of commercial law, for-profits operating under reasonably competitive conditions are likely to be more efficient and innovative than public actors.<sup>3</sup> This argument rests in turn upon important assumptions about determinants of the relative competence of private and public actors, including both the *incentives* that public and private actors have to provide rules that are valued by parties to commercial transactions, and the *resources* they can draw upon to create those rules.

There are several reasons to believe that for-profits differ systematically from other actors in terms of their incentives to provide commercial law efficiently. For instance, in an article co-authored with Eric Talley Hadfield claims that although for-profits' incentives to provide differentiated 'products' to 'consumers' of corporate law may not be socially optimal, in competitive settings their offerings will be closer to being

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<sup>2</sup> See, *Privatizing Commercial Law; On Public versus Private Provision of Corporation Law*; and, *The Public and the Private*.

<sup>3</sup> In this context efficiency means that goods are produced at the lowest possible cost, given the producer's existing knowledge (productive efficiency), and that the prices of those goods are set at levels that approach the costs of production, and that goods are allocated to those who value them most highly (allocative efficiency). This essay follows Hadfield in assuming that the primary objective of the rules that govern contractual relations between legal entities such as corporations is to maximize efficiency, although I will pay more attention than she does to externalities associated with the production of commercial law.

optimal than those of legislatures.<sup>4</sup> In making this argument Hadfield and Talley rely heavily on the rather cynical assumption that the individuals who control public actors are motivated primarily by the prospect of receiving personal benefits. Starting from this premise they reason that the incentives of public actors are compromised because their members receive limited personal benefits from maximizing public revenues. Consequently, elected officials will have only attenuated incentives to maximize public revenues from attracting the business of incorporating firms. Reasoning by analogy implies that elected officials will have similarly attenuated incentives to provide rules to govern the enforcement of commercial transactions.

Even public actors motivated by public interests may have limited incentives to produce optimal rules. This is particularly true when it comes to the rules that govern international commercial transactions. The gains from commercial transactions are usually divided between the parties to the transaction. Thus, if a public actor invests in improving the rules that govern international commercial transactions a portion of the benefits will typically redound to foreign actors. As a result, public actors whose objective is to maximize the benefits that flow to local actors, or who simply attach more weight to the interests of local actors than foreign actors, will not have incentives to invest in improving the regime to the point that maximizes global gains from trade. So for example, when developing procedural rules of general application local lawmakers may fail to take sufficient account of the benefits of harmonization with the law of other jurisdictions since some of the benefits will accrue to foreign firms.

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<sup>4</sup> Hadfield and Talley, *On Public versus Private Provision of Corporate Law*. Snyder, *supra* note 2, also stresses the importance of competition among private lawmakers.

On the other hand it seems unreasonable to presume that for-profits always have superior incentives to provide commercial rules. Such rules are a form of intellectual property. For-profits' incentives to invest in creating and disseminating intellectual property depend on the extent to which their ideas can be appropriated without compensation, which in turn depends on factors such as their ability to assert copyright and the feasibility of placing physical or electronic restrictions on distribution.<sup>5</sup> There is no particular reason to believe that those incentives are, on balance, socially optimal.<sup>6</sup> More generally, it is well-understood that a variety of 'market failures' can undermine for-profits' incentives to make socially optimal decisions. For-profit producers have limited incentives to minimize (maximize) negative (positive) externalities created by their activities, abide by unenforceable commitments, or refrain from exploiting market power or superior information.<sup>7</sup>

For-profits and public actors can also differ in terms of the *resources* they can draw upon to create and implement rules. Public actors may have limited fiscal resources because ideological or legal factors constrain their ability to impose taxes or user fees or to set aside public resources for the benefit of commercial actors. But it is not clear that public actors generally face greater fiscal constraints than private organizations. In any event, advocates of privatization tend to stress the importance of access to another kind of

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<sup>5</sup> Hadfield and Talley *On Public versus Private Provision of Corporate Law*, 439 (acknowledging that promoting innovation by private actors may require public intervention designed to reward innovative producers with limited amounts of market power); Hadfield, *The Public and the Private*, 249-250 (same). Cf. *Privatizing Commercial Law*, 44, 45 (arguing that for-profit producers of commercial law are likely to be relatively innovative).

<sup>6</sup> Here it is particularly important to distinguish the incentives of organizations, of any kind, from those of their agents. Agents incentives to innovate may be influence by additional factors such as, on the one hand, the desire for fame or career advancement, or, on the other hand, leisure. See, Clayton P. Gillette, *Harmony and Stasis in Trade Usages for International Sales*, 39 *Virginia Journal of International Law* 707, 734-735 (1999).

<sup>7</sup> Hadfield and Talley briefly acknowledge the prospect of such market failures in *On Public versus Private Provision of Corporate Law* at p. 439.

resource, namely, information. Hadfield and others emphasize the fact that private actors, collectively, may have more expertise than public actors because they can draw upon a broader range of information.<sup>8</sup> In particular, communities of merchants can draw upon their experience to formulate laws that best fit their needs. This argument is less than compelling though because it is unclear why for-profits are likely to be any better than public actors at tapping the information possessed by merchants. In principle, the state should be just as capable as a private firm of hiring individuals with commercial experience and allowing its agents to solicit information from merchants.

The proponents of privatization of commercial law must also confront the fact there is one resource to which public actors typically have better access than private actors: coercive force. While states do not necessarily have a monopoly on the use of force within their territory, states usually try to discourage private actors from using force for the purposes of enforcing commercial obligations, and well-ordered states tend to be quite successful in enforcing those restraints. This means that private actors engaged in enforcing commercial obligations will either have to find alternatives to forcible enforcement – of which there are several – or solicit the assistance of at least one public actor.<sup>9</sup>

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<sup>8</sup> Benson, *supra* at 650; Lisa Bernstein, Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry, 21 *Journal of Legal Studies* 115 (1992); Avinash Dixit, *Lawlessness in Governance and Economics* (Princeton: Princeton University Press, 2004).

<sup>9</sup> As far as alternatives are concerned, Benson, *supra*, argues that the history of the law merchant suggests that commercial boycotts can serve as substitutes for coercive enforcement. Bernstein *supra* makes similar claims about more recent enforcement of obligations among Jewish diamond dealers. For general discussions of alternatives to third party enforcement as methods of inducing firms to perform their obligations see: Benjamin Klein and Keith B. Leffler, The Role of Market Forces in Assuring Contractual performance, 89 *Journal of Political Economy* 615 (1981); Lester G. Telser, A Theory of Self-Enforcing Agreements, 53 *Journal of Business* 27 (1980); and Oliver E. Williamson, Credible Commitments: Using Hostages to Support Exchange, 73 *American Economic Review* 519 (1983); David E. Charny, Nonlegal Sanctions in Commercial Relationships, 104 *Harvard Law Review* 373 (1990).

*Application to international commercial adjudication*

For the foregoing reasons purely theoretical arguments that for-profits are better placed than public actors to govern commercial transactions efficiently are inconclusive. So what does the evidence say?

We can begin by examining a context in which the argument in favor of relying on for-profits seems strongest, namely, adjudication of international commercial disputes. Why focus on adjudication? After all, adjudication is only one of three main stages in the governance of international commerce, the others being, making rules and, when necessary, enforcing the rulings of an adjudicator. The answer is that, as we have seen, the risk of unauthorized copying may undermine for-profits' incentives to make socially optimal rules. At the same time, lack of direct access to coercive force may limit for-profits' enforcement capabilities. However, neither of these problems should affect for-profits' competence to engage in adjudication.

One could argue that public actors still have an advantage in undertaking adjudication because rule-making, adjudication and enforcement are often bundled together by providers of 'dispute resolution' services and public actors are in the best position to provide at least two elements of the bundle. But as noted above, public actors' incentives to invest in governance of *international* commercial disputes are attenuated by the fact that a portion of the benefits will flow to foreign actors. In addition, a public actor's superior access to coercive force within a particular territory may be less significant in the international context where enforcement is likely to entail coordination of the use of force across multiple jurisdictions. So far inter-jurisdictional efforts to coordinate enforcement of judgments rendered by publicly-sponsored courts

have been relatively unsuccessful, at least when compared to efforts to coordinate enforcement of the awards of private arbitrators.<sup>10</sup>

### 3. Forms of adjudication in international commerce

Does current practice bear out the claim that for-profits have an advantage in adjudicating international commercial disputes? The main approaches to adjudicating such disputes are as follows:

- \_ Internal processes
- \_ Commercial arbitration
- \_ Investor-state arbitration
- \_ Courts

As we shall see, each of these forms of adjudication is associated with particular organizational forms, personnel and procedural rules, some of which straddle the public/private divide. No single organizational form appears to play a dominant role.

#### *Internal bodies*

When disputes arise in commercial transactions the parties to such agreements often try to resolve them internally, that is to say, without referring them to a third party. This process is often conceptualized as a form of ‘bargaining in the shadow of the law’, meaning that it involves negotiation by interested parties rather than adjudication by an independent actor. However, when the parties to the agreement are large organizations,

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<sup>10</sup> See Jens Dammann and Henry Hansmann, Globalizing Commercial Litigation, 94 *Cornell Law Review* 1, 33 (2008).

as is typically the case in international commercial transactions, internal dispute resolution mechanisms can look more like adjudication than negotiation.

Large organizations can often find personnel who are relatively independent of the personnel responsible for negotiating or performing a contract to adjudicate any disputes that arise. In fact, Gilson, Sabel and Scott claim that governance mechanisms that involve such ‘contract referees’ are common in contracts that contemplate deeply collaborative relationships.<sup>11</sup> So for example, some contracts specify that disputes concerning parties’ obligations are to be referred initially to an inter-firm group that is directly responsible for overseeing the collaboration, then to senior Vice Presidents for each firm, and then, if necessary, up the respective firms’ hierarchy to the two CEOs. These party-affiliated referees are still far from impartial. But Gilson et al. claim that the knowledge they bring to the dispute resolution process offsets, at least to some extent, their partiality.

### *Institutional arbitration*

It is often useful to have disputes resolved by a true third party. In many international commercial transactions the parties specify that the third party will be a private arbitrator.

There are two basic kinds of international commercial arbitration: institutional and ad hoc. Institutional arbitration involves the adjudication of a dispute by an arbitrator under the auspices of an organization known as the arbitration institution. The services provided by the arbitration institution often include: default procedural rules; lists of

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<sup>11</sup> Ronald J. Gilson, Charles F. Sabel and Robert E. Scott, Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration, 109 *Columbia Law Review* 431, 480 (2009).

potential arbitrators (as well as, if necessary, names of specific arbitrators); guidelines for arbitrators' fees; custody of documents and funds; registration and archiving of filings and correspondence; physical facilities for hearings; mechanisms for resolving disputes over procedural rules. In return the arbitration institution is typically paid a fee which typically includes both a fixed and a variable component. The variable component may depend on the amount at issue in the dispute or the time spent by the arbitration institution in administering the case.<sup>12</sup>

Well known international commercial arbitration institutions include the American Arbitration Association's International Centre for Dispute Resolution (ICDR), the China International Economic and Trade Arbitration Commission (CIETAC), the Hong Kong International Arbitration Centre (HKIA), the International Chamber of Commerce's International Court of Arbitration (ICC), Judicial Arbitration and Mediation Service (JAMS), the London Court of International Arbitration (LCIA), and the Singapore International Arbitration Centre (SIAC). The World Intellectual Property Organization (WIPO) also provides an arbitration facility designed primarily for disputes concerning intellectual property.

Interestingly, all but two of these institutions are organized as not-for-profit entities. One of the exceptions is JAMS, which is a for-profit based in the United States.<sup>13</sup> The other exception is WIPO, which is an international organization. There is, however, variation among the not-for-profit institutions. The LCIA was originally

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<sup>12</sup> "The LCIA's registration fee is £1,500... Thereafter, hourly rates are applied by both the LCIA and its arbitrators, with part of the LCIA's charges calculated by reference to the tribunal's fees." See, <http://www.lcia-arbitration.com/>. By contrast under the ICC rules administrative expenses and arbitrators' fees are based on the sum in dispute. See *ICC Rules of Arbitration*, "Appendix III: Arbitration Costs and Fees", Art. 4., available online at <http://www.iccwbo.org/court/arbitration/id4093/index.html>.

<sup>13</sup> JAMS Arbitration, Mediation and ADR Services | About JAMS | Overview | About-JAMS, [http://www.jamsadr.com/aboutus\\_overview/](http://www.jamsadr.com/aboutus_overview/) (last visited July 22, 2010).

administered by the City of London Corporation and the London Chamber of Commerce.<sup>14</sup> Meanwhile CIETAC,<sup>15</sup> HKIA,<sup>16</sup> and SIAC<sup>17</sup> were all initially sponsored, at least to some extent, by their respective governments.

Commercial actors who choose institutional arbitration do not always look for wholly independent institutions; in some cases they look to arbitral institutions with which they have fairly strong economic ties. The classic examples are actors who choose arbitrations run by international trade associations. Trade associations concern themselves primarily with disseminating market information, lobbying various regulators, and producing standard form contracts for the benefit of their members. But a few of them also provide arbitration services. The most notable examples are the Federation of Oils, Seeds and Fats Associations (oilseeds, oils and fats, and groundnuts)<sup>18</sup> and the Grain and Feed Trade Association (grain and feed).<sup>19</sup> These trade associations are also organized as non-profit entities.

Credit card processing companies also provide arbitration institutions that are not wholly independent of the disputants.<sup>20</sup> These arbitrations are designed to resolve disputes that arise between issuers of credit cards and the banks of merchants who accept credit cards (these banks are called “acquirers”). Many of these disputes are initiated by

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<sup>14</sup> The London Court of International Arbitration, [http://www.lcia.org/PRINT/LCIA\\_history\\_print.html](http://www.lcia.org/PRINT/LCIA_history_print.html) (last visited July 22, 2010).

<sup>15</sup> CIETAC was established in 1956 under the China Council for the Promotion of International Trade (CCPIT) which was then a government agency, but CIETAC is now said to be financially independent of the Chinese government. *See*, Taroh Inoue, Introduction to International Commercial Arbitration in China, 36 *Hong Kong Law Journal* 171, 175-6 (2006).

<sup>16</sup> Hong Kong International Arbitration Centre – About the HKIAC, [http://www.hkiac.org/show\\_content.php?article\\_id=1](http://www.hkiac.org/show_content.php?article_id=1) (last visited July 22, 2010).

<sup>17</sup> International arbitration centre set up in S'pore, *Straits Times*, 6 July 1991; Ang Yong Tong, SIAC: Arbitration in the New Millenium, *Singapore Law Gazette*, January 2000, available online at: <http://www.lawgazette.com.sg/2000-1/Jan00-23.htm> (last visited August 5, 2010).

<sup>18</sup> Fed. of Oils, Seeds & Fats Ass'ns, <http://www.fosfa.org>.

<sup>19</sup> Grain & Feed Trade Ass'n, <http://www.gafta.com>.

<sup>20</sup> Andrew P. Morriss and Jason A. Korosec, Private Dispute Resolution in the Card Context: Structure, Reputation, and Incentives, Case Legal Studies Research Paper No. 05-12 (2005).

customers who claim that their credit card statement reflects unauthorized or incorrect charges, or charges for defective merchandise.<sup>21</sup> The process serves to determine which financial institution should bear responsibility for a charge. The responsible institution will often pass the charge on to a cardholder or merchant as the case may be. Consequently, the outcome of the dispute resolution process is of interest to merchants and cardholders, even though they are not strictly speaking parties to the proceedings. The credit card processors are far from independent third parties to these disputes since they have contractual relationships with the disputants and participate in the series of transactions that give rise to the disputes.

The two major credit card processing companies, Visa and MasterCard, began life as cooperatives owned by their member banks.<sup>22</sup> In the United States both are now publicly-traded for-profits. MasterCard changed its ownership and governance structure in a process that concluded in 2006;<sup>23</sup> Visa followed in 2007.<sup>24</sup> The dispute resolution procedures described above pre-date the change in ownership structure.<sup>25</sup> In Europe, Visa continues to be organized as a member-owned firm.<sup>26</sup>

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<sup>21</sup> In these proceedings arbitration is only the final stage in a highly structured process that requires issuers and acquirers to classify their reasons for asserting and rejecting charges using numerical classification schemes, to collect and provide particular kinds of evidence, and to transmit information in prescribed electronic formats in a prescribed sequence and within prescribed time limits. If a party (typically the issuer) decides to initiate arbitration, limited opportunities to submit additional evidence are provided. Rights of appeal are also limited. For a general description of these procedures see Morriss and Korosec, *supra*.

<sup>22</sup> See MasterCard, Corporate Overview | The MasterCard Worldwide Story | MasterCard® | MasterCard®, [http://www.mastercard.com/us/company/en/ourcompany/the\\_mastercard\\_story.html](http://www.mastercard.com/us/company/en/ourcompany/the_mastercard_story.html) (last visited July 22, 2010); Visa Inc., Registration Statement, Form S-4 under the Securities Act of 1933, filed with the Securities Exchange Commission on June 22, 2007, p. 37.

<sup>23</sup> MasterCard Incorporated, Prospectus dated May 24, 2006.

<sup>24</sup> Visa Inc., Registration Statement, *supra*.

<sup>25</sup> Compare Morriss and Korosec, *supra* with Visa, *Visa International Operating Regulations – Dispute Resolution Rules* (November 2, 2009), available online at [http://corporate.visa.com/\\_media/VIOR-DisputeResolutionRules.pdf](http://corporate.visa.com/_media/VIOR-DisputeResolutionRules.pdf) and MasterCard Worldwide, *Chargeback Guide* (April 16 2010), available online at [http://www.mastercard.com/us/merchant/pdf/TB\\_CB\\_Manual.pdf](http://www.mastercard.com/us/merchant/pdf/TB_CB_Manual.pdf).

<sup>26</sup> See, Visa Europe, About Us – Management and Governance, available online at [http://www.visaeurope.com/en/about\\_us/management\\_and\\_governance.aspx](http://www.visaeurope.com/en/about_us/management_and_governance.aspx);

### *Ad hoc arbitration*

Many international commercial arbitrations are not administered by any arbitration institution but instead are governed by ad hoc arrangements formulated by the parties to the transaction. In these cases the arbitrators are private individuals selected in accordance with the mechanism selected by the parties. These arbitrators are typically either agents of for-profit law firms or sole proprietors. The procedural rules are also specified by the parties, who often draw on previous agreements as well as rules formulated by either an arbitration institution or an international organization such as the United Nations Commission on International Trade Law (UNCITRAL).

### *Investment arbitration*

International commercial disputes in which one of the parties is a state can be resolved through institutional or ad hoc commercial arbitration, but they can also be resolved using mechanisms specially designed for disputes between states and foreign investors. The most important mechanism of this sort is the International Centre for Settlement of Investment Disputes (ICSID). Many modern investment treaties require disputes involving a state party on the one hand and, on the other hand, investors who are nationals of the other state party, to be submitted to some form of international arbitration, and ICSID arbitration is commonly listed as one of the options.<sup>27</sup>

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<sup>27</sup> See Gary B. Born, *International Commercial Arbitration* 107, (rev. and expanded ed. 2009). For a model clause, see ICSID Model Clauses I.B.2, <http://icsid.worldbank.org/ICSID/StaticFiles/model-clauses-en/7.htm#a> (last visited July 23, 2010).

ICSID is an international organization created by a multilateral treaty that entered into force in 1966.<sup>28</sup> It was designed to provide a mechanism for resolving disputes between member states and investors who qualify as nationals of other member states (with the consent of the disputing parties). Since 1978 ICSID's facilities have also been available for the resolution of other kinds of disputes. Like other arbitration institutions ICSID provides procedural rules (ICSID actually has two separate sets), a panel of arbitrators, physical facilities for hearings, and various administrative services. These services can be unbundled, in the sense that ICSID will provide administrative services in connection with ad hoc proceedings that are not governed by its procedural rules. The World Bank covers the costs of the ICSID Secretariat but the costs of proceedings are borne by parties to the dispute.

### *Judicial proceedings*

International commercial disputes can also be resolved in proceedings administered by national courts. Courts are the quintessential examples of publicly-sponsored organizations but it is worth keeping in mind that private actors play a significant role in some judicial proceedings. For instance, in some jurisdictions tribunals that preside over commercial cases – at least in the first instance – include lay people selected for their business acumen; sometimes the panel is composed entirely of lay

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<sup>28</sup> *Convention on the Settlement of Investment Disputes Between States and Nationals of Other States*, produced at Washington, D.C., 18 March 1965. Found at 575 U.N.T.S. 159 (No. 8359) (1966), available at [http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=ShowHome&pageName=Documents\\_Home](http://icsid.worldbank.org/ICSID/FrontServlet?requestType=CasesRH&actionVal=ShowHome&pageName=Documents_Home) (last visited July 23, 2010).

judges.<sup>29</sup> In other cases publicly-employed judges rely on private-sector experts or are at least willing to entertain arguments from representatives of the business community.

#### 4. A new theoretical model

The dispute resolution mechanisms listed above have all been in existence for many years and are well known. Moreover, choice-of-forum and arbitration clauses are regularly enforced. As a result, commercial parties interested in specifying how their disputes will be resolved have many options to choose from.

The variety of organizational forms represented among those options is striking. Parties to international commercial transactions do not face a binary choice between for-profits on the one hand and wholly public national courts on the other hand. To be sure there are examples of for-profit providers, including arbitration institutions such as JAMS, Visa and MasterCard, as well as the individuals who serve as arbitrators in ad hoc arbitrations. But the providers of dispute resolution mechanisms also include not-for-profit trade associations (GFTA), other not-for-profit organizations enjoying various levels of state support (ICC, LCIA, SKIA), member-owned firms (Visa and MasterCard in Europe), international organizations (WIPO and ICSID), and national courts staffed or advised, in whole or in part, by private individuals or organizations.

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<sup>29</sup> See, e.g., Amalia D. Kessler, Marginalization and Myth: The Corporatist Roots of France's Forgotten Elective Judiciary, 58 *American Journal of Comparative Law* 679, 681 (2010) ("In this other, ignored component of the French judicial system, judges lack formal judicial (and usually legal) training of any kind and are elected mid career to serve temporary terms of office. Those thus elected to office belong to the particular professional (and social) groups whose disputes they will resolve and which, in turn, are responsible for electing them."); Adrian Vermeule, Should We Have Lay Justices? 59 *Stanford Law Review* 1569, 1573 (2007) ("In the United Kingdom . . . lay magistrates or justices of the peace hear certain classes of civil and criminal cases."; "[In] the Amtsgericht [Germany], which hears civil and less serious criminal cases, one professional judge sits with two lay judges.")

This evidence suggests that a satisfactory theory of the relationship between organizational form and ability to resolve commercial disputes has to account for the possibility of dispute resolution being provided simultaneously by a variety of organizations, including hybrids. It is clearly unrealistic to assume that for-profits and national courts are the only two options.

A theory of this sort is sketched below. The building blocks are the same as Professor Hadfield's: the efficiency with which any given kind of organization provides dispute resolution services depends on the extent to which it has appropriate incentives or resources.<sup>30</sup> However, at each step the theory takes into account the possibility that a non-profit or international organization, or some sort of hybrid organization, will be more appealing than either a for-profit entity or a national court.<sup>31</sup>

#### *Incentives to behave opportunistically*

Commercial parties often select providers of dispute resolution mechanisms at the outset of their relationship and long before any dispute has arisen. In making their choices parties will tend to favor providers who can be counted on to perform commitments to provide dispute resolution services, that is to say, commitments that may be long term and inherently difficult for third parties, or even the commercial parties themselves, to enforce. This in turn implies that commercial parties will favor providers

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<sup>30</sup> Here I follow Hadfield in focusing on the efficiency implications of alternative ways of adjudicating disputes. A more expansive analysis would pay greater attention to factors such as whether the dispute resolution provider in question is democratically accountable and respects values such as individual autonomy and equality. These issues have been discussed extensively in the literature on private rule-making. See, for example, Snyder, *supra* note 2, 425-437; Colin Scott, Regulating Private Legislation, in *Making European Private Law*, Fabrizio Cafaggi and Horatia Muir-Watt (eds), (Northampton: Edward Elgar, 2008), 254-268; Janet Koven Levit, Bottom-Up Lawmaking: The Private Origins of Transnational Law, 15 *Indiana Journal of Global Legal Studies* 49 (2008).

<sup>31</sup> The material which follows draws on Kevin E. Davis, The Role of Non-profits in the Production of Boilerplate, 104 *Michigan Law Review* 1075 (2006).

who do not face incentives either to shirk their responsibilities or to take risks that jeopardize their ability to fulfill those responsibilities.

As Henry Hansmann has shown, for-profits are not ideally suited to be dependable trading partners.<sup>32</sup> The reason is simple: for-profits deciding whether to invest resources in ensuring that they perform their obligations can be expected to respond primarily to financial incentives. If obligations are so difficult to enforce that there is no financial penalty for poor performance, then there is no reason to expect a for-profit to try to deliver anything better. By contrast, not-for-profits and public actors lack similar financial incentives to shirk their obligations and so may be more dependable.

This general point suggests that for-profit providers of dispute resolution mechanisms will, all other things being equal, be less dependable than not-for-profits or public bodies. Consider for example, an arbitral institution deciding whether to make costly investments in screening the arbitrators it appoints to chair proceedings for conflicts of interest. Assume that disputing parties would benefit from having their institution provide a list of pre-screened arbitrators, even if only as a starting point in the process of deciding who will ultimately adjudicate their dispute. Finally, imagine a situation in which no one is in a position to impose a financial penalty on the institution for failing to invest in screening. In these circumstances, parties choosing between institutions can expect any for-profit institution they select to respond to the incentive to shirk its ‘responsibilities’ and refrain from screening. In addition, a for-profit institution is likely to respond to financial incentives that require positive action – such as announcing surprise fee increases after parties have selected them – that can be equally

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<sup>32</sup> See, e.g. Henry Hansmann, *Ownership of Enterprise* 24-34 (1996); Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 *Yale Law Journal* 835, 868-872 (1980).

pernicious. Finally, in deciding whether to make risky investments that have the potential to threaten its survival—consider for example a risky expansion into a new overseas market—a for-profit institution has no incentive to consider the interests of commercial parties whose plans for dispute resolution will be disrupted if the institution fails. Knowing all this, commercial parties ought to systematically favor not-for-profit or public arbitration institutions over for-profits.

There are, of course, ways in which for-profit institutions can compensate for the limitations inherent in their organizational form. One way is to provide a warranty, that is to say, some sort of legally enforceable commitment.<sup>33</sup> For a provider of dispute resolution services this would mean signing contracts with commercial parties who intend to use its services. Those contracts would contain legally binding commitments to meet certain performance standards. Moreover, sanctions for breach of those standards would have to be sufficient either to deter breach or provide satisfactory compensation. Ideally, the contracts would be formed at the time the parties selected their provider so as to guard against the risk of opportunistic behavior between the time of selection and the time a dispute arises. Interestingly though, parties typically contract with arbitration institutions only after a dispute has arisen and those contracts generally disclaim liability for all but deliberate wrongdoing.<sup>34</sup> This may reflect the difficulty of verifying

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<sup>33</sup> Stephen J. Choi, The Problem with Arbitration Agreements, 36 *Vanderbilt Journal of Transnational Law* 1233, 1238 (2003) (asserting the value of permitting parties to tailor the liability of arbitrators by contract); Peter B. Rutledge, Toward a Contractual Approach for Arbitral Immunity, 39 *Georgia Law Review* 151 (2004) (same).

<sup>34</sup> See, for example, JAMS, *JAMS International Arbitration Rules*, Article 1.6; International Chamber of Commerce, *Rules of Arbitration*, Article 34, available online at <http://www.iccwbo.org/court/arbitration/id4199/index.html> (last visited August 20, 2010); London Court of International Arbitration, *Arbitration Rules*, Article 31.1, available online at [http://www.lcia.org/Dispute\\_Resolution\\_Services/LCIA\\_Arbitration\\_Rules.aspx#article31](http://www.lcia.org/Dispute_Resolution_Services/LCIA_Arbitration_Rules.aspx#article31) (last visited August 20, 2010); Singapore International Arbitration Centre, *Arbitration Rules of the Singapore*

compliance with the kinds of commitments that would be valuable to consumers of dispute resolution services.

A second way in which a for-profit provider might enhance its credibility is by exposing itself to the prospect of substantial loss in the event that it defaults on its obligations. In other words, it can post a bond.<sup>35</sup> The most straightforward way to do this is to invest in establishing a reputation for providing high-quality services that will be destroyed in the event of a scandal. So for example, an arbitration institution could invest so much in advertising the integrity of the arbitrators it appoints as chairs that it would suffer prohibitive losses if it failed to invest in proper screening and one of its chairs proved to be corrupt. Similar, individual arbitrators might be motivated to avoid conflicts of interest by the fear of tarnishing their reputation in the legal community and losing future business.

Unlike a warranty, a reputational bond need not involve casting commitments in legal form, nor does it require the invocation of costly legal proceedings in the event of default. On the other hand, a reputational bond does not serve to compensate disappointed stakeholders in the event of default—in our example, the arbitration institution's loss would not be the clients' gain. Reputational mechanisms also do not necessarily have the most reliable enforcement mechanisms—the media may be inconsistent in its taste for and ability to uncover scandal and social networks may be incomplete. Moreover, some firms' public relations advisers may be better than others at blunting the impact of scandal.

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*International Arbitration Centre* (4th Edition, 1 July 2010), Article 34.1. For an overview of the law concerning the legal liability of arbitrators see, Fabrizio Cafaggi, [conference background paper].

<sup>35</sup> For discussion of such bonds see the references cited in note 9, *supra*.

Both warranties and reputational bonds only work if defaults are observable by the affected party. It helps if they are also verifiable by third parties. This is because neither mechanism works unless defaults can be detected by parties in a position either to enforce the warranty or damage the dispute resolution provider's reputation. This in turn suggests that both warranties and bonds are likely to be particularly effective if combined with some sort of credible commitment to transparency. So for example, an arbitration institution could make a commitment to regular reporting of its performance and submit to audits of its reports by independent third parties. In practice though, the fact that commercial parties typically have an interest in keeping their disputes confidential counteracts any such incentives to provide transparency.

It is only fair to note that even if for-profit firms face inherent limits on their dependability that cannot be fully overcome by warranties or reputational bonds, not-for-profits, international organizations or hybrid organizations may not be perfectly dependable either. It would be convenient to assume that for-profits always strive to maximize financial returns while the other types of organizations are faithfully committed to promoting the interests of disputants. But that assumption is unlikely to be universally valid. For example, if dispute resolution is only one of many activities pursued by a not-for-profit or international organization it may wish to use the profits from dispute resolution to subsidize other activities. Not-for-profits or international organizations in this situation can be predicted to behave in exactly the same way as for-profits. Similarly, if a not-for-profit depends for its survival on revenue from disputants and faces significant competition (from either for-profits or other non-profits) then it may be just as responsive to financial incentives as any for-profit. Generally speaking, the

assumption that not-for-profits are immune to financial incentives generated by disputants is only plausible for organizations that can count on financing from other sources, such as donors or members or the profits associated with the exercise of market power.

It is also important to consider the possibility that the behavior of any given organization will reflect the interests of the individuals who staff it rather than organizational objectives. There is reason to believe that these sorts of ‘agency costs’ will be particularly significant in organizations which have no residual financial claimants. Residual financial claimants such as the shareholders in a for-profit corporation have a strong incentive to hold agents of the organization accountable. In their absence, agents of the organization, including the agents who deliver dispute resolution services, may have a great deal of latitude to pursue their own interests.<sup>36</sup> Those interests can be quite varied. For example, some agents may be inclined to shirk their responsibilities simply in order to enjoy more leisure time. Alternatively, some agents, particularly senior managers, may wish to maximize profits because they benefit indirectly in the form of higher salaries and greater job security. On the other hand, staff motivated by professional pride might have interests that are fairly well aligned with broader organizational objectives such as promoting the interesting of disputants.

#### *Incentives to mitigate externalities*

So far we have discussed reasons why for-profits motivated exclusively by financial interests will tend to ignore the effects of their decisions on disputants who hope to benefit from their services. Similar reasoning shows that for-profits that fit this

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<sup>36</sup> This is not to deny that for-profit firms can be affected by agency costs.

description will tend to ignore ways in which their resolutions of disputes affect the broader public.<sup>37</sup>

There are several ways in which the adjudication of an international commercial dispute can affect the broader public.<sup>38</sup> To begin with, the outcome of the dispute may have important distributional effects. This is most likely to occur in high-stakes cases where the decision transfers substantial amounts of wealth from individuals located in one country to individuals located in another. The most important examples of such cases are investor-state arbitrations in which damages ranging into the hundreds of millions of dollars have been awarded against relatively poor states.<sup>39</sup>

Adjudication can also have normative effects.<sup>40</sup> To the extent that reasons for decisions are made public they can shape other parties' views on how laws of general application or widely used contractual language will or should be interpreted. This is true even when the decisions do not technically qualify as binding precedent. By condemning or condoning particular conduct – whether it happens to be failure to mitigate damages or bribery of a public official – each decision has the potential to influence the norms that govern subsequent international commercial dealings. Moreover, even if a particular decision does not shift anyone's beliefs about the prevailing norms, it may influence the level of certainty surrounding those beliefs. These normative effects are particularly

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<sup>37</sup> The arguments in this section are more fully developed in Kevin E. Davis and Helen Hershkoff, Contracting for Procedure, *William & Mary Law Review* (forthcoming).

<sup>38</sup> Robert S. Wai, Transnational Liff-off and Juridical Touchdown: The Regulatory Function of Private International Law in an Era of Globalization, 40 *Columbia Journal of Transnational Law* 209, 236-238, (2002); A. Claire Cutler, *Private Power and Global Authority: Transnational Merchant Law in the Global Political Economy* (New York: Cambridge University Press, 2003).

<sup>39</sup> See e.g., CMS v. Argentina, Award, May 12, 2005, 44 ILM (2005) 1205 (annulled in part by decision dated 25 September 2007); *Lauder v. Czech Republic*, Award, September 3, 2001, 9 ICSID Reports 66.

<sup>40</sup> Landes and Posner, *supra* note 2, 238-240; Owen Fiss, Against Settlement, 93 *Yale Law Journal* 1073, 1085-87 (1984).

significant in investor-state dispute resolution where the norms being established concern the appropriateness of government policies that affect entire societies.<sup>41</sup>

Adjudication can also affect the world beyond the parties to the dispute by influencing the production of information. To begin with, adjudication inevitably generates information about the facts of the transaction giving rise to the dispute. When those facts involve misconduct such as bribery or sale of defective products, third parties may find the information very valuable. Information about the dispute resolution process itself may also be of value to third parties. For example, information about successful procedural innovations may be of considerable value to other providers of dispute resolution services. In fact, even information about snags encountered in a particular proceeding may be useful as a spur to subsequent procedural innovation.

Finally, the provision of dispute resolution services by a particular actor to a particular set of clients has the potential to affect, either for better or worse, the accountability of other providers to other actors. For example, a new arbitral institution might attract clients who would otherwise do a great deal to hold publicly-sponsored courts accountable for poor performance. The consequent reduction in accountability of the courts could easily have a negative effect on less vocal litigants who lack access to the arbitral forum. Alternatively the new arbitral institution could have the positive effect of stimulating healthy competition for litigants.<sup>42</sup>

Providers of dispute resolution services make many decisions that affect the welfare of third parties along these dimensions. Individual adjudicators naturally bear

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<sup>41</sup> Benedict Kingsbury and Stephan Schill, *Investor-State Arbitration as Governance: Fair and Equitable Treatment, Proportionality and the Emerging Global Administrative Law*, in *50 Years of the New York Convention, ICAA Congress Series no 14* (Albert Jan van den Berg, ed., Kluwer, 2009).

<sup>42</sup> Hansmann and Dammann, *supra* note 10, 21-23. See also, Clayton P. Gillette, *Opting Out of Public Provision*, 73 *Denver University Law Review* 1185 (1996).

primary responsibility for the impact of decisions on third parties. But on the margins the processes that govern the vetting and selection of adjudicators seem likely to influence the pattern of outcomes. So for instance, the approach that an arbitration institution takes toward selection of arbitrators seems likely to determine whether arbitrators in their pool typically approach their task primarily as a technical problem, a problem of giving effect to the will of the parties, or as problem of balancing the will of the parties against rights and duties owed to the general public. Meanwhile, the procedural rules that providers of dispute resolution services adopt will determine the evidence that is gathered in connection with each dispute, how vigorously factual claims are contested, the extent to which third parties are permitted to make arguments and the overall level of transparency concerning the proceedings. Finally, the members of any given dispute resolution organization can devote more or less resources to constructive criticism of other providers of dispute resolution services.

Theory predicts that for-profit organizations will only take the interests of third parties into account in their decision-making to the extent that they derive some financial benefit from doing so. To the extent that providers of dispute resolution services are paid by their potential disputants – some for-profits are likely to have other sources of revenue, especially arbitrators that are sole proprietorships – and those disputants are themselves devoted to profit-maximization it is difficult to see why for-profit providers would design their processes to permit third parties’ interests to affect the outcome.<sup>43</sup> Why would profit-maximizing commercial actors choose a dispute resolution mechanism

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<sup>43</sup> The discussion here assumes that providers of dispute resolution services are not subject to legal liability for failing to protect the interests of third parties. For a proposal that involves the imposition of such liability see, Andrew T. Guzman, *Arbitrator Liability: Reconciling Arbitration and Mandatory Rules*, 49 *Duke Law Journal* 1279 (2000).

that permits its processes to be delayed by interventions from NGOs? Why would they submit themselves to the uncertainty of publicly-oriented rules like the doctrine of public policy? Why would they lobby for continued investment in the publicly-sponsored courts? Thus, the demand for publicly-oriented dispute resolution from firms that focus exclusively on maximizing financial returns seems likely to be small. If there is any such demand it is likely to come from commercial actors who wish to cultivate a reputation for social responsibility, or governments who feel bound to uphold public interests even when they engage in commercial dealings. This suggests that for-profits might find niche markets for publicly-oriented approaches to resolving disputes between states and foreign investors as well as disputes among large firms committed to social responsibility.

It is unclear to what extent providers of dispute resolution services capture financial benefits from producing information about their activities. The disputants typically will not pay for the production of such information.<sup>44</sup> However, as we have already seen, a commitment to transparency can be useful as a way of reassuring potential clients about the value of a dispute resolution mechanism.

Broad dissemination of information about a particular mechanism's procedural rules can also be a useful way of attracting new clients in settings where network externalities are significant. Network externalities arise where the value derived from use of a product is an increasing function of the number of users. This can occur with dispute resolution mechanisms: the cost of using a particular mechanism may decline as the

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<sup>44</sup> Landes and Posner suggest that for-profit judges might publish their opinions on the law as a way of advertising their competence and impartiality. They go on to note, however, that the absence of written opinions in commercial arbitration suggests that other forms of advertising are more effective. See, *Adjudication as a Private Good*, 238-9.

number of attorneys familiar with its practices increases, both because of the effects of competition among attorneys and because inexperienced attorneys may delay proceedings. A rational for-profit provider might respond to this phenomenon by subsidizing the dissemination of information about its procedural rules.

It is also difficult to generalize about the extent to which not-for-profits or international organizations that provide dispute resolution services will take public interests into account. As we have already seen, this will depend in part on the extent to which those organizations are immunized from financial pressures to cater exclusively to the interests of disputants. A great deal also seems to turn on the mandate of the organization, which in turn seems likely to be a function of its membership.<sup>45</sup> For instance, a trade association whose members are drawn exclusively from the for-profit members of a particular industry has little incentive to design a dispute resolution mechanism that takes broader interests into account. As for international organizations, in principle they represent the interests of member states but in practice they represent the interests of member states' *governments*. Those governments may have good reasons to disregard broader interests in social responsibility or transparency or to neglect the task of monitoring staff of the organization. Another point to keep in mind is that the members of a not-for-profit or international organization may have conflicting views on how to protect the public interest. It is not difficult to imagine disagreements between publicly and privately held firms, or between more and less democratic countries, on issues such as whether arbitral proceedings ought to be open to the public.

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<sup>45</sup> See Wai, *supra* note 38, 258-264 for a general discussion of how the interests and values of private actors influence international commercial law. Clayton P. Gillette and Robert E. Scott, *The Political Economy of International Sales Law*, 25 *International Review of Law and Economics* 446 (2005) examine how participants' interests influence specific kinds of rule-making processes in international commercial law.

### *Access to volunteers*

For-profits may also differ from not-for-profits in the sense that they enjoy different levels of access to the resources required to provide dispute resolution services. One such resource is volunteer labor.<sup>46</sup>

Having the option of tapping volunteers to assist in the design or operation of a dispute resolution mechanism may be quite advantageous. One reason is that it may be difficult for users of a dispute resolution mechanism to assess its quality. Consequently, for-profit providers have an incentive to shirk on any commitments to provide high quality services. Devices such as warranties and bonds (reputational or otherwise) can mitigate this problem. To the extent that these fail, however, it will be helpful if internal factors such as altruism, professional pride or the desire to exercise and improve skills motivate agents to exert themselves. This will frequently be true of volunteers. So for example it may be useful for an arbitration institution to create a volunteer advisory board whose members provide information on how to improve the overall quality of its services.<sup>47</sup> On the other hand, there is no guarantee that volunteers' internal motivations will align their interests with those of either disputing parties or the public.

Volunteers may also be helpful in generating innovations in procedural rules. It is difficult for any single person, or even small group of people, to foresee all of the cases in which a given set of procedural rules might be applied. For this reason it may be ideal to

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<sup>46</sup> The term volunteers is used broadly here to refer to any individual or organization which provides goods or services on terms that are more favorable than fair market value.

<sup>47</sup> See, for example, SIAC's Council of Advisors which is described as "a number of respected arbitration practitioners and counsel who will act on a voluntary basis to offer their expertise and assistance to the SIAC Board.":

[http://www.siac.org.sg/cms/index.php?option=com\\_content&view=article&id=50&Itemid=70](http://www.siac.org.sg/cms/index.php?option=com_content&view=article&id=50&Itemid=70).

have such rules reviewed by a large group of individuals, even if each member of the group only devotes a relatively small amount of time to the task. The reason is that if the group is sufficiently diverse each member will bring different experiences to the table and will identify and focus on different circumstances in which the rules might be applied.<sup>48</sup> In addition, allowing readers to play a role in selecting the problems upon which they focus may be a useful way to harness the private information that they possess about their own capabilities. Providing monetary compensation to members of such a large group might be prohibitively costly, because of both the transaction costs of processing payments and the difficulty of assigning a price to each contribution. If, however, the members of the group provide their services on a voluntary basis then this sort of collective enterprise becomes a viable mode of production. In fact it may be superior to production by a smaller group whose members provide their services in exchange for monetary compensation.<sup>49</sup>

For-profits may have less access to volunteers than other kinds of organizations. Leaving aside altruism,<sup>50</sup> many people volunteer in order to socialize or to exercise and hone their professional skills or to obtain status in the eyes of their peers. There is no obvious reason why these sorts of benefits cannot be obtained by volunteering on behalf of a for-profit enterprise. However, for some people the direct personal benefits they could receive from volunteering on behalf of a for-profit organization might be

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<sup>48</sup> Cf. “Given enough eyeballs, all bugs are shallow.” Eric Steven Raymond, *The Cathedral and the Bazaar* (Version 3.0, 2000), <http://www.catb.org/~esr/writings/cathedral-bazaar/cathedral-bazaar> (follow “Release Early, Release Often” hyperlink) (last visited Aug. 2, 2005).

<sup>49</sup> This is the logic that has been offered to explain the success of open source software projects and other instances of what Yochai Benkler calls peer production. See, Yochai Benkler, Coase’s Penguin, or, Linux and The Nature of the Firm, 112 *Yale Law Journal* 369 (2002).

<sup>50</sup> I am dubious whether many actors in this sector are motivated primarily by altruism in the sense of being interested in benefiting, for example, ‘the members of the grain and feed industry’, or ‘inhabitants of countries seeking foreign investment.’ To the extent there are such altruists, they are even more likely than other actors to be dissuaded from volunteering for a for-profit by the concerns set out below.

outweighed by an aversion to gratuitously conferring benefits on the owners of a for-profit organization.<sup>51</sup> This aversion might lead even people who are not exactly altruistic to prefer to volunteer for not-for-profits. It is unclear, however, how prevalent this attitude is. In fields such as software development and the publication of academic journals people frequently volunteer to benefit for-profit organizations.<sup>52</sup> For-profit firms also are frequently able to induce their customers to provide volunteer labor in forms that range from responses to customer satisfaction surveys to voluntary transfers of significant technological innovations.<sup>53</sup>

#### *Access to tax-exempt capital*

In many countries, including the United States, for-profits enjoy less favorable tax treatment than not-for-profits. Under U.S. law not-for-profits are exempt from certain state and local taxes, most notably franchise and property taxes.<sup>54</sup> These exemptions clearly give not-for-profits a competitive advantage over for-profits by lowering their relative costs of production. Many not-for-profits are also exempt from federal income tax, which tends to reduce their cost of capital.<sup>55</sup> To see this, consider the following

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<sup>51</sup> The existence of such an aversion seems particularly plausible when the for-profit organization is a competitor. So for instance, law firms might donate their services to a trade association but not to another private law firm.

<sup>52</sup> Benkler, *supra* note 49, at 440–41 (discussing whether possibility of others benefiting discourages voluntary participation in information production).

<sup>53</sup> For discussion of more extreme examples, *see* Dietmar Harhoff, Joachim Henkel & Eric von Hippel, Profiting From Voluntary Information Spillovers: How Users Benefit by Freely Revealing Their Innovations, 32 *Research Policy* 1753 (2003) (discussing when and why users voluntarily reveal innovations to suppliers).

<sup>54</sup> The details vary from state to state. *See generally* Frances R. Hill & Barbara L. Kirschten, *Federal and State Taxation Of Exempt Organizations* ¶ 14.04 (1994).

<sup>55</sup> I.R.C. § 501(c) (2000) (listing exempt organizations). § 501(c)(6) refers to “[b]usiness leagues, chambers of commerce, real-estate boards, boards of trade, or professional football leagues (whether or not administering a pension fund for football players), not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.” Income from exempt not-for-profits’ unrelated business activities – that is to say, activity unrelated to the purposes that form the basis of

example. Suppose that an organization needs to raise \$10,000 to finance the creation of an arbitration institution. Assume that the normal after-tax rate of return on an investment in a venture such as this would be 10 percent and that the tax rate is 30 percent. If the organization is a for-profit it will have to provide an investor with an after-tax return of \$1,000, meaning that it will have to earn roughly \$1428.57 in before-tax income. Suppose, however, that the organization is a tax-exempt not-for-profit. In this case it might try to finance the business by charging its members dues in return for an implicit promise to provide dispute resolution services at below-market prices in the future. In a sense therefore, the members can be characterized as “investors.” Assume that, like other investors, they demand a return of 10 percent on their investment. Notice that the not-for-profit will only have to earn \$1000 in before-tax income to generate this return. This means that the not-for-profit will be able to charge a lower price for its services than a for-profit while still generating an acceptable return for its investors. Alternatively, it can charge the same price and generate a relatively high return for its investors, thus encouraging them to invest.<sup>56</sup>

#### *Access to public subsidies*

Subsidies from public bodies constitute a significant source of funding for some providers of dispute resolution services (see, for example, ICSID). It would be unwise

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the not-for-profit’s exemption – is subject to a federal tax called the unrelated business income tax (“UBIT”). However, for many not-for-profits providing dispute resolution services seems unlikely to qualify as an unrelated business activity. I.R.C. § 511(a) (2000). See Henry B. Hansmann, Unfair Competition and the Unrelated Business Income Tax, 75 *Virginia Law Review* 605, 609–12 (1989).

<sup>56</sup> The consequences would be similar if not-for-profits were not exempt from income taxation but typically were able to avoid generating taxable income by offsetting income from business activities with expenses incurred in providing benefits to members. However, Internal Revenue Code § 277 limits the scope for this practice. That provision prevents certain non-tax-exempt organizations from treating expenditures on member benefits as deductions from income generated from business activities.

for a public body to provide such a subsidy without taking steps to control the use of funds. In principle it would be possible to assert such control over a for-profit by, for example, using a contract that contains appropriate performance standards. In practice though it might be difficult to attain the requisite level of control without relying on a more direct form of oversight, such as a seat on the board of directors of the organization. This suggests that organizations designed to attract public subsidies ought to be controlled, at least to some extent, by public actors. This hypothesis would explain the existence of both wholly public and hybrid (public-private) organizations.

#### *Access to information*

In resolving commercial disputes it is often helpful to have prior familiarity with the underlying transaction. Access to specialized information does not seem to be systematically related to organizational form. For example, in some contexts the individuals with greatest access to relevant information can be found within the disputing parties themselves. On other occasions a trade association will have the best access to expert decision-makers since its *raison d'être* is to maintain relationships with a broad range of industry professionals. In still other cases an intermediary like Visa or Mastercard will have the requisite expertise. As these examples suggest, the situation is further complicated by the fact that there is typically a trade-off between expertise and impartiality: individuals or organizations that are familiar with a transaction may also be connected to the parties in a way that creates bias in favor of one party or another.

## 5. Conclusion

Commercial law represents the infrastructure of international commerce. As with other forms of infrastructure, the case for provision by for-profit actors is complex. Conventional economic theory suggests that under certain conditions for-profits offer advantages in terms of efficiency and innovativeness. However, other theoretical considerations point in different directions. For one thing, for-profits do not have obvious incentives to be dependable providers of high-quality services, particularly for parties to long-term contracts. They also lack incentives to take public interests into account when determining the outcomes of disputes. Moreover, there are circumstances in which for-profits will be at a disadvantage to other institutions in terms of access to labor, capital or information.

These theoretical observations are consistent with evidence that actors involved in adjudication of international commercial disputes take a variety of organizational forms. On the other hand, both the theoretical and the empirical analyses set out above are too preliminary to show precisely when any given organizational form is optimal, from the perspective of either the parties to commercial transactions or society as a whole. Therefore the lesson seems to be that a great deal remains to be learned about how international commerce is actually governed, but taking organizational form into account adds an important dimension to the inquiry.