

On the Future of Law in the Information Society

My grandfather was a district judge. He usually made his way on foot from town to town in the Pongau district, observing his judicial duties. People asked him for advice and for help in settling their differences. He not only pronounced on the law; for the people he was the law. As this image suggests, life was simpler back then. A very specific social institution—the court system—was entrusted with the task of applying democratically legitimized rules to concrete conflicts, thus preserving peaceful coexistence under the law.

Even today, we still hold onto the key elements of this picture. Our codes of criminal and civil procedure grant judges considerable power in conducting their proceedings. On the European continent, we rarely find the charged atmosphere that accompanies the intellectual and rhetorical duels between the legal counsels we are used to seeing in American television series and movies. Instead the social consensus has put the reins firmly in the hands of the judge. This is possible, according to the widespread view, because our law is codified and therefore clear-cut—utterly unlike the Anglo-American common law, in which the lawyers help judges to select applicable precedents. Back in the early 19th century, an American judge might still have been able to maintain an overview of the existing case law, but judges today looking for precedents would drown helplessly in a sea of possible cases if the attorneys weren't there to throw them a line. And this is exactly what most people here think is the difference between the common law system of the US and the civil law in continental Europe. In Europe, we presume that the one holding the truth is confirmed in his position by non-partisan courts, while we suspect on the other side of the Atlantic the party with the better legal counsel always wins.

An analysis of the decisions by the U.S. Supreme Court seems at first to confirm this view. While in the 19th century the highest judge in the USA could make do with a few hundred judicial precedents, today there are several thousand available. From 1960 to 2000, the number of precedents cited per page of a high court decision went up an impressive 60 percent. The Supreme Court has long since accepted the fact that lawyers submit to it increasingly lengthy briefs citing relevant precedents. This situation invites the conclusion that justice is on the side of the party with the better resources.

However, surprisingly the situation is not so much different in continental Europe. Let's take a look at how the highest courts in Austria are using precedents in reaching their decisions. Yes, the US Supreme Court cites precedents more than twice as often today as it did in 1960. But Austria's highest courts have also doubled their references to precedents within the same period—despite the fact that Austria has a civil, not a common law system. And the increase in the use of precedents is not only developing similarly in the two countries in relative terms, but on an absolute basis as well, with similar numbers of citations per page of a decision. Why is this trend of such central significance?

Law in transition

These results show that the law as an institution is undergoing a fundamental transition.

- Law is becoming more case-dependent, particularly in continental Europe. Our legal system today has little in common with the image of my grandfather, with the idea that one can apply the codified letter of the law to the case at hand as if it were a mathematical formula.

We are experiencing a changeover to a hybrid system combining statutory and case law.

- Law is thus becoming increasingly diffuse, unable to be forced into a simple corset of clear-cut rules. This means that there is less clarity for those subject to the law.
- As the clarity of the law wanes, so does the role of the courts as social institution for predictable conflict resolution.
- In an era of increased legal uncertainty, citizens are searching for security. To the extent that the courts no longer fulfill this need, the significance of the legal profession rises.

There is no doubt about it: law is in transition. Nevertheless, one might be tempted to conclude that its role as social institution for conflict resolution and avoidance is still undisputed. But that as well would be a delusion. And this brings me to the second point of my remarks.

Law as we know it is a child of a territorially anchored nation state. It subjects relatively homogeneous groups in a contiguous region to a uniform system of rules and it works because most of the conflicts that need to be resolved come about between people living under a single legal system. The interfaces between different legal systems are where the system is doomed to crack. Ever since the end of the Second World War, we have been trying to solve interjurisdictional interface challenges through formal and informal harmonization of laws. This is successful when the nation states involved desire a solution and are willing to accept the necessary changes to their own legal systems. Internationalization fails, however, when legal systems rest on fundamentally different values that the states are not willing to compromise. So far, national law utilizing these patches has fared relatively well. The challenge of cross-border radio and television as well as the worldwide telex and telephone network have been managed accordingly: as a relatively small number of transaction partners which were able to agree on special rules negotiated within a designated international discussion framework, with the express purpose of keeping cross-border effects on the respective national legal systems to a minimum.

Then Internet came along and destroyed this equilibrium — but not in the way you might at first think.

Many have argued that as the Internet makes it possible to distribute and access information worldwide, information providers and recipients can change their location at any time and without major transaction costs to circumvent territorial legal restrictions. If Internet gambling is against the law in the US, one can just set up a server in Costa Rica, Moscow, or Kuala Lumpur. This kind of arbitrage arguably undermines and marginalizes the law.

Today I believe that this view is incorrect. Despite the Internet, national legal systems have repeatedly been able to call those to account who deliberately ventured outside the law in their Internet dealings. It is often claimed that this is tantamount to subjecting everyone on the Internet to the law of every nation on earth. If a European posts a nude photo on his homepage, she risks criminal prosecution in the USA or in Saudi Arabia. But that of course is not the case. In fact, courts have relatively rarely applied the laws of one country to an operator in another, and usually only when the behavior of the operator was systematically geared toward creating negative spillover effects.

There is another Internet phenomenon that challenges the law. Amazon, the online store that originally rose to fame by selling books, has customers in 200 nations. Amazon's revenues in 2006 were 10 billion dollars. On its peak sales day last year, December 11, 2006, Amazon received over four million individual orders. Amazon sends its products to customers in countries with unclear legal systems and questionable legal security. But the online giant still delivers to them without concern. There are two reasons for this: for one, the financial risk associated with each

individual order is relatively low. Second, Amazon makes use of an institution—the credit card—that (mostly) guarantees payment and does so for a small fraction of the total cost of the transaction.

Credit cards as an alternative to law?

No other institution calls territorial law into question like this one. The bundle of services offered by credit card providers is impressive. They offer not only transaction processing, but also assume contractual liability in many cases. If someone discovers a fraudulent charge on their credit card statement, it usually is reverted quickly by the credit card company without the need for any formal legal proceedings. Transactional conflict is resolved in accordance with rules set down by the credit card system. These everyone must obey if they want to continue using their credit cards in the future. The limited number of major credit card providers means that if one breaks their rules, and thus is barred from having access to a credit card, one has to reckon with substantial inconvenience and costs. The system functions to a great extent independently from national legal systems and is therefore applicable worldwide.

This does not imply that credit card providers do not themselves employ legal measures to obtain their money. But they control their risk mainly through extraordinarily skillful data mining of millions of daily transactions, thereby rapidly detecting any unusual transactional patterns that are then subjected to closer scrutiny.

Amazon provides a crude first approximation of what I would like to call institutional change. The law as a mechanism for resolving and avoiding conflicts is being augmented by new intermediaries, new institutions. But in the case of Amazon, millions of purchasers are at least dealing with a single identifiable seller. This results largely in a one-sided risk: Amazon must ensure that its customers pay, and uses an intermediary for that purpose. For the customers, Amazon's brand usually suffices.

The situation is different when buyers and sellers do not know each other and still want to do business. This is *eBay's* market—a place in which anyone can buy and sell products. It has over 133 million participants, who were involved in more than 172 million single transactions in the fourth quarter of 2006. More than 11 billion dollars in sales were realized via *eBay* during that quarter. The value of most of the transactions is under USD 150, but *eBay* also maintains the largest used car market in America—with transaction values in the thousands and tens of thousands of dollars.

Because consumers are not themselves authorized to accept credit cards as payment, *eBay* cannot hope that credit card companies would bare the transactional risks. Who then is *eBay's* new intermediary? The lawyers might say: why does *eBay* need a new intermediary? The intermediary already exists. It's called the law. That is absolutely correct. But *eBay* does not view the law as an appropriate partner—not because the contracts concluded on *eBay* are outside of the legal system. That is not the problem. The founders of *eBay* were simply not convinced that customers would be willing to take legal action for conflicts that in most cases were not worth more than a few hundred dollars. Legal proceedings would simply be too costly and *eBay* customers facing a loss may opt to leave *eBay's* marketplace rather than pursue costly legal action. That of course was not in *eBay's* interest. Hence, *eBay* developed three mechanisms to assume the role that credit companies play at Amazon. These three mechanisms form the foundation for *eBay's* success as a marketplace.

Three alternative mechanisms for transaction protection

First: Every transaction partner at *eBay* rates the other following the conclusion of the transaction. As everyone can view the previous ratings of a potential transaction partner, reputations of each market participant emerge. The beauty of the system is that it pools knowledge about transaction partners. Reputation in turn is nothing more than the hope that the past is a useful predictor of the future. Sellers with a better reputation can demand more for the same product as luxury labels and hip restaurants know all too well.

The rating system on *eBay* has been amazingly effective—it has reduced the number of conflicts much more than when credit cards are used, and done so at far lower cost. For *eBay* ratings are cheap: they only had to put the ratings infrastructure in place, while the transaction partners are the ones who rate one another. Remarkably, the overwhelming majority of transaction partners actually do take the time to rate the people they do business with, even if they do not directly profit from doing so.

Second, *eBay* purchased its own payment system, PayPal, which not only allows for cash-free transactions but can also, if requested, assume a significant portion of the transactional risk. This works like credit cards: *eBay* charges the transaction partners a percentage of the transaction value. In the fourth quarter of 2006, this fee was 3.66 percent of the value of the transaction concluded via PayPal—an amount that was offset by only 0.41 percent of direct cost for *eBay*.

Third, *eBay* offers transaction partners the option of resolving disputes via mediation. To this end, *eBay* signed an agreement with Squaretrade.com that provides inexpensive and rapid mediation via the Internet. In the last few years, Squaretrade with its three dozen or so staff members has successfully settled over two million conflicts in 120 countries. In addition to *eBay*, over 50,000 other online providers now also use the services of Squaretrade.

Ratings, quasi-credit cards and online mediation. These are the three mechanisms chosen by *eBay* to ensure the security of transactions on its site. *eBay*'s enormous success proved its strategy right, even if detailed research in recent years has shown that the mechanisms can and are deliberately abused.

For the moment we conclude that the case of *eBay* shows how national law is being overlaid and at times even supplanted as the societal conflict avoidance and resolution institution of choice by other mechanisms. But importantly this process of displacement is not taking place where one might have expected—cross-border transactions, but rather at the millions of everyday transactions between individuals in the same country, precisely for whom national laws were after all designed. Law is challenged on its own turf by other mechanisms because it has lost its appeal as a conflict resolution mechanism.

The (nonsensical) response of the legislators

Legislators sometimes think that the correct response to this situation is to pass more laws, in order to provide a tighter legal grip on eCommerce and online marketplaces. This is absurd in both economic and social terms. Those who use *eBay* have not decided against using the law because law is not applicable, but rather because, in their opinion, the law does not offer any competitive advantages over other mechanisms, such as ratings and mediation. Just as preposterous is the opposite view: that without law there would be no more conflicts, i.e. that disputes can be completely avoided through mere reputation and risk distribution.

Rather, the task is to make law attractive enough so that people use it again. There are a number of obvious ways. Lawmakers can reduce the costs and time required for legal action. They can raise incentives for victims of blatant contract violations through punitive damages. And they can deliberately raise the cost of alternative systems of conflict resolution. What all of these options have in common is that they make the law economically more attractive relative to other mechanisms.

Where they differ is in who shoulders the cost. If lawmakers lower court fees, the general public must pay the difference. Punitive damages impose the costs on the losing party, while higher prices for alternative mechanisms are paid primarily by the participants in online marketplaces. I am mentioning this only because the suggestion of making the law more attractive sounds good at first, but it is not cost-free.

Moreover, economic theory speaks against this approach. If an institution like the law no longer fulfills its assigned role and other mechanisms and institutions have to step in and take on part of its duties, then society may be economically better off not fighting it. It would just be wasting resources on an institution that has outlived its utility.

The necessity of rethinking the law

We are tempted to view law as something static, as a solid rock defying the waves of constant change. But law is a social construct. It is an institution that we have created for a very specific purpose. Whenever the law as we know it—territorially anchored and formally legitimated—no longer fulfills its task as a societal institution because people no longer make use of it, its significance will necessarily wane. This creates a vacuum that is being filled. Other institutions and mechanisms come in to take its place.

And that brings me to the core of my thesis: Whoever defines law narrowly as an institution of the nation-state must fear today for its continued existence. Only through state intervention and economic inefficiency will we be able to preserve this traditional system of law. But whoever conceives of law more broadly as an institution for societal conflict avoidance and conflict resolution will recognize the current development as an important institutional change.

Let me explain this using an example. You all know about the significance of Internet domain names. For years, domain name disputes were regularly brought before the courts. This not only involved expensive and prolonged proceedings, but also favored the wrongful owner of a domain name. She was able to continue using the name as long as the legal question had not been sufficiently clarified.

This situation was changed a while ago for generic top level domains (among others domain names that end in *.com* and *.net*). Disputes over such domain names must now first be submitted to arbitration. Whoever wins the arbitration round is recognized by the domain name system as rightful administrator of the domain name until a valid court decision says otherwise. If one does not accept the arbitrator's decision, the losing party can still take legal action. But because that takes a long time in many countries, the arbitrator's decision is rarely challenged. As a rule of thumb, the arbitrator's decision is final, which in turn significantly enhances the standing of the arbitration procedure.

How does this arbitration procedure work, and who decides which party is right? The answer may be surprising. In practice, the procedure takes place completely via email, and the decision is handed down within 14 days after the arbitration panel has been called in. A new group of intermediaries helps to put together the arbitration panel. Anyone can become an arbitrator

who fulfills the requirements of the intermediary. This is almost as if the courts were to compete with one another and the parties in the dispute could choose which court they would like to appeal to. The arbitrators in turn apply substantive and procedural rules that have not been set down by any legislator but instead by a corporation in California. In the last few years, tens of thousands of domain name disputes have been settled in this fashion.

This is the institutional change I am talking about: competing arbitration providers carry out proceedings on the basis of rules that have not been democratically legitimized, culminating in decisions of considerable economic import for those involved.

This arbitration procedure has been vehemently criticized in academic literature. People claim that justice is being sold here. A thorough analysis carried out by the Max Planck Institute for Intellectual Property showed, however, that the arbitrators' decisions were not that bad, perhaps because the arbitrators are usually lawyers who have frequently dealt with domain disputes in their daily practice and can thus demonstrate a well-grounded stock of expert knowledge. The study also determined that the fairness of the procedures is by all means comparable with that of our national legal system. This is perhaps the objective reason for the widespread (subjective) acceptance of the arbitration process by most of the parties to disputes.

This new generation of law, of efficient, peacemaking conflict resolution for our society: a new institution that applies rules legitimated by the market and by prior decisions, attaining results that are recognized by the overwhelming majority of those subject to these rules. It does not rely on national law and national courts, but offers fairness and the ability to resolve conflicts.

These intermediaries have become indispensable. Allow me to cite one last example: *Second Life*, a virtual three-dimensional world, is currently all the rage. Almost anything you can do in the real world you can do via your avatar in *Second Life*. You can communicate with one another, chat, dance, sing, do sports, attend concerts or go shopping. Some 300,000 users all over the world spend an average of more than 20 hours a week inworld. A good million visit *Second Life* less often. Virtual houses or virtual clothing can be purchased for money—real money. Participation in *Second Life* is free, but if you want to secure a piece of virtual land to build a virtual house or virtual store on, you have to lease it from *Second Life's* provider. *Second Life's* economy is flourishing: some 540 million US dollars are spent each year in hundreds of millions of individual transactions. Here we have hundreds of thousands of people from across the globe living together intensively in a virtual world. To nobody's surprise, *Second Life* has its disputes and conflicts. National courts are not suitable for resolving such conflicts. Yet, participants in *Second Life* have not yet begun to create democratic structures. There is no legal system in *Second Life*, no courts and no state police. Millions of participants have simply not seen any need for such things. *Second Life* functions without them. Advocates of a narrow definition of law might be shocked.

Instead, market demand has created two institutions: a mediation service (that struggles to find enough business) and a notary to certify electronic documents—an institution for conflict resolution and one for conflict avoidance.

Of course, every change means taking leave of familiar things. I, too, am saddened at first to see the traditional legal system legitimated by our national parliaments dwindling in significance. But as our society changes, its institutions must change along with it. Yet, we should not fear the future. The institutions, processes and rules for conflict avoidance and conflict resolution will change, but the example of *Second Life* is a case in point that the need for law as an institution for resolving conflict remains.

Translated from German by Jennifer Taylor-Gaida

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