

## Law, the State, and Private Ordering: Evolutionary Explanations of Institutional Change

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### A. Transformations of the State: Legal Certainty in Globalized Exchange Processes

The societal mega-trends of the past four decades, such as a globalizing economy and an aging society, have challenged the understanding of the state in OECD countries. The resulting “transformations of the state” are the subject of an interdisciplinary research agenda established at the Collaborative Research Center (CRC) 597 in Bremen, Germany.<sup>1</sup> A total of twenty projects from political science, law, and economics explore changes of statehood which take place in two different dimensions: first, the internationalization and, second, the privatization of activities and functions which were traditionally performed by and ascribed to the democratic, constitutional and interventionist state. While the first research phase (2003-2006) aimed at founding empirical descriptions of these internationalization and privatization processes, the current phase (2007-2010) is dedicated to explaining the observed changes in statehood.<sup>2</sup> Within this general framework, the authors’ research project on “New Forms of Legal Certainty in Globalized Exchange Processes” deals with changes in the institutional organization of commerce.

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<sup>1</sup> For the research programme see [www.sfb597.uni-bremen.de](http://www.sfb597.uni-bremen.de).

<sup>2</sup> The results of the different projects are summed up in two edited volumes: TRANSFORMATIONS OF THE STATE? (Stephan Leibfried and Michael Zürn eds., 2005) and TRANSFORMING THE GOLDEN AGE NATION STATE (Achim Hurrelmann, Stephan Leibfried, Kerstin Martens and Peter Mayer eds., 2007).

In spite of all efforts to harmonize private law and to facilitate judicial cooperation,<sup>3</sup> the state and its legal system still appear largely unable to effectively regulate global commerce. Depending on the specifics of the involved jurisdictions, cross-border transactions face varying degrees of legal uncertainty. In sum, international trade operates under circumstances which are appropriately described under the eye-catching term of "lawlessness".<sup>4</sup> At the same time, a plethora of private governance mechanisms are available to international commerce. Occasionally, such private legal services are bundled into effective private governance regimes or private legal systems, stepping in the place of national regulatory structures.<sup>5</sup> Empirical research, conducted as part of the above mentioned research project during the past four years, has revealed an increasing *transnationalization* as a basic pattern in the governance of cross-border transactions.<sup>6</sup> Triggered by the globalization of commerce, economic governance, understood as the provision of "good order and workable arrangements"<sup>7</sup> for business dealings, is fundamentally transformed: as governance mechanisms become increasingly decoupled from state legal systems they are at the same time *internationalized* and *privatized*.

In international trade, private governance mechanisms provide for what used to be thought of as a genuinely sovereign affair: legal certainty. Important strands of both legal and economic theory have long regarded legal certainty as inextricably linked to the state legal system. In jurisprudence, legal certainty is predominantly defined as consisting of two components: predictability of legal decisions on the one hand, and enforceability of individual claims on the other hand.<sup>8</sup> For classical legal thought, these functions seemed to be perfectly enshrined in the nation-state and its institutions. This jurisprudential perspective significantly overlaps with conventional wisdom in economic theory that defines contract enforcement and the

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<sup>3</sup> For the failed Hague Judgements Convention see e.g. Graf-Peter Calliess, *Value-added Norms, Local Litigation, and Global Enforcement: Why the Brussels-Philosophy failed in The Hague*, 5 GERMAN LAW JOURNAL 1489 (2004).

<sup>4</sup> See further, AVINASH K. DIXIT, *LAWLESSNESS AND ECONOMICS: ALTERNATIVE MODES OF GOVERNANCE* (2004).

<sup>5</sup> See e.g. Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 JOURNAL OF LEGAL STUDIES 138 (1992); Gunther Teubner, *Contracting Worlds: The Many Autonomies of Private Law*, 9 SOCIAL AND LEGAL STUDIES 399 (2000).

<sup>6</sup> See Graf-Peter Calliess, Thomas Dietz, Wioletta Konradi, Holger Nieswandt & Fabian Sosa, *Transformations of Commercial Law*, in *TRANSFORMING THE GOLDEN AGE NATION STATE*, 83 (Achim Hurrelmann, Stephan Leibfried, Kerstin Martens and Peter Mayer eds., 2007).

<sup>7</sup> Oliver E. Williamson, *The Economics of Governance*, 95 AMERICAN ECONOMIC REVIEW 1 (2005).

<sup>8</sup> For a recent elaboration of this jurisprudential perspective, see further, ANDREAS VON ARNAULD, *RECHTSSICHERHEIT. PERSPEKTIVISCHE ANNÄHERUNGEN AN EINE "IDEE DIRECTRICE" DES RECHTS* (2006).

guarantee of property rights as the fundamental, taken-for-granted features of any (state) legal system.<sup>9</sup> Human rights and the basic values of a society are conceived as “fundamental institutions”<sup>10</sup>, the state and its legal system, in turn, directly derived from these fundamental institutions and therefore to a large extent frame-giving as well.

However, our studies on off-shoring in the software industry,<sup>11</sup> the international timber trade HELMUT DIETL, INSTITUTIONEN UND ZEIT (1993).<sup>12</sup> and the role of international law firms,<sup>13</sup> have shown that business actors in cross-border situations increasingly tend to rely on transaction-type or industry specific governance regimes, recombined from different public and private mechanisms of control, when it comes to the enforcement of their mutual obligations.<sup>14</sup> Instead of exclusively or at least predominantly relying on the state legal system, these regimes build on “relational contracting”,<sup>15</sup> “social sanctions”,<sup>16</sup> alternative dispute resolution<sup>17</sup> and other kinds of private governance, while public institutions like contract law, courts, or legal sanctions are of rather peripheral importance. Thus, “institutions (...) to create order and reduce uncertainty in exchange”<sup>18</sup> gradually emerge outside

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<sup>9</sup> DIXIT, *supra* note 4, 2-4.

<sup>10</sup> HELMUT DIETL, INSTITUTIONEN UND ZEIT (1993).

<sup>11</sup> Thomas Dietz & Holger Nieswandt, *Cross-Border Cooperation. The meaning of Cognitive and Normative Expectations for the Emergence of Global Research and Development Cooperation*, TranState Working Paper No. 49/2007 (2007), available at <http://www.sfb597.uni-bremen.de/pages/pubApBeschreibung.php?SPRACHE=de&ID=59>, last accessed: 17 March 2008.

<sup>12</sup> Wioletta Konradi, *Lex mercatoria als globales Recht der Wirtschaft? Die Koordination der Internationalen Transaktionen am Beispiel der Holzindustrie*, TranState Working Paper No. 56/2007 (2007), available at <http://www.sfb597.uni-bremen.de/pages/pubApBeschreibung.php?SPRACHE=de&ID=64>, last accessed: 17 March 2008.

<sup>13</sup> FABIAN SOSA, VERTRAG UND GESCHÄFTSBEZIEHUNG IM GRENZÜBERSCHREITENDEN WIRTSCHAFTSVERKEHR (2007).

<sup>14</sup> Calliess/Dietz/Konradi/Nieswandt/Sosa, *supra* note 6.

<sup>15</sup> See further, Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 55 AMERICAN SOCIOLOGICAL REVIEW 86, (1963); Ian R. MacNeil, THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN CONTRACTUAL RELATIONS (1980).

<sup>16</sup> Most prominently ERIC A. POSNER, LAW AND SOCIAL NORMS (2000)

<sup>17</sup> See generally ALAN REDFERN & MARTIN HUNTER, LAW AND PRACTICE OF INTERNATIONAL COMMERCIAL ARBITRATION (2004), para. 1-69 et seq.

<sup>18</sup> Douglas C. North, *Institutions*, 5 JOURNAL OF ECONOMIC PERSPECTIVES 97, (1991); see also JOHN R. COMMONS, INSTITUTIONAL ECONOMICS. ITS PLACE IN POLITICAL ECONOMY (1934).

the state legal system. These institutions, however, are not the product of political will or of any legislative process, but the mere result of the trial-and-error interaction of market participants.

The general aim of our research in the current phase (2007-2010) is to explain these changes in the institutional organization of commerce. Against this background, it seems a challenging endeavor to conceptualize the emergence, competition and adaptation of transnational economic governance structures beyond the nation-state. For the described mixture of public and private governance mechanisms and the absence of a central coordination in their use, we believe that any theory aiming at such explanation must begin with two fundamental assumptions: first, the limitedness of individual knowledge, and, second, the growing complexity of social interaction that renders impossible any attempt to fully anticipate – and thus regulate – societal processes.<sup>19</sup> The conference on “Law, The State, and Evolutionary Theory” held in Bremen in October 2007 intended to bring together the contributions of different branches of evolutionary theory that aim at explaining institutional change.

In this introductory article to the conference volume, we undertake to outline some elements of a conceptual framework for explaining processes of institutional change from both an economic and a legal perspective. Specifically, it shall be explored how institutions can be stable enough to provide agents with reliability and at the same time flexible enough to take into account emergent changes in their environment. Knowing that institutions might be “rigid”,<sup>20</sup> there is still a huge research gap regarding the chances for and the limits of institutional change. In the following we will give a short overview of the basic elements of evolutionary models in the social sciences (*infra* B.I) before hinting at two distinct perspectives on their possible use for a theory of institutional change: an institutional economics perspective on the one hand (*infra* B.II) and a systems theory-informed legal theory approach on the other (*infra* B.III). We will then conclude our brief inquiry with a tentative outlook on the possibilities and the problems of integrating evolutionary theory into a social science analysis of institutional change (*infra* C).

## B. Evolutionary Perspectives on Law and Globalization

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<sup>19</sup> See further, STEFAN OKRUCH, *INNOVATION UND DIFFUSION VON NORMEN* (1999), 146-7.

<sup>20</sup> Michael T. Hannan and John Freeman, *Structural Inertia and Organizational Change*, 49 *AMERICAN SOCIOLOGICAL REVIEW* 149 (1984); JÖRG FREILING, *RESSOURCENORIENTIERTE REORGANISATIONEN: PROBLEMANALYSE UND CHANGE MANAGEMENT AUF DER BASIS DES RESOURCE-BASED VIEW* (2001).

The basic tenet of evolutionary theory is agreed upon in every discipline: "*history matters*".<sup>21</sup> And if it holds true that "history (...) is largely a story of institutional evolution",<sup>22</sup> then it is only logical that the concept of evolution itself has moved into the focus of the social sciences. What evolutionary theory, generally speaking, seeks to explain is the mechanisms of a change in structures over time. Evolution as a descriptive concept, however, is used in a variety of disciplines. Building upon the analysis of species evolution as a biological phenomenon by Lamarck<sup>23</sup> and in the seminal work of Darwin,<sup>24</sup> the concept has soon crossed disciplinary boundaries and spread to fields as diverse as theology, cosmology, stellar astronomy, and – in the realm of the social sciences – sociology, political science, law, business and economics.<sup>25</sup> This development has been mainly triggered by the emergence of empirical scientific methods in the 19<sup>th</sup> century which has fundamentally transformed the style of argumentation and the production of knowledge in all academic disciplines.<sup>26</sup> Therefore, it can be very difficult to recognize to what extent the terminology of evolution is used in a merely metaphorical way and to what extent it is actually employed as an analytical framework for research.<sup>27</sup>

### *I. Elements of a Theory of Change*

In the terminology of Burrell and Morgan,<sup>28</sup> most evolutionary theories can be described as following an *interpretive paradigm*, which means that they focus on

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<sup>21</sup> For example, David Teece, Gary Pisano & Amy Shuen, *Dynamic Capabilities and Strategic Management*, 18 DYNAMIC CAPABILITIES AND STRATEGIC MANAGEMENT 509 (1997).

<sup>22</sup> NORTH, *supra* note 18.

<sup>23</sup> JEAN-BAPTISTE LAMARCK, PHILOSOPHIE ZOOLOGIQUE (1809).

<sup>24</sup> CHARLES DARWIN, ON THE ORIGIN OF SPECIES BY MEANS OF NATURAL SELECTION OR: THE PRESERVATION OF FAVOURED RACES IN THE STRUGGLE FOR LIFE (1859).

<sup>25</sup> For example, GREGORY BATESON, STEPS TO AN ECOLOGY OF MIND. COLLECTED ESSAYS IN ANTHROPOLOGY, PSYCHIATRY, EVOLUTION, AND EPISTEMOLOGY (1972); KENNETH E. BOULDING, ECODYNAMICS. A NEW THEORY OF SOCIETAL EVOLUTION (1978); Albert G. Keller, *Law in Evolution*, 28 YALE LAW JOURNAL 769 (1919); FRIEDRICH AUGUST VON HAYEK, KNOWLEDGE, EVOLUTION AND SOCIETY (1983).

<sup>26</sup> For the impact on jurisprudence see RAINER-MARIA KIESOW, DAS NATURGESETZ DES RECHTS (1997), especially chapter IV.

<sup>27</sup> See NIKLAS LUHMANN, LAW AS A SOCIAL SYSTEM 230 (Fatima Kastner, Richard Nobles, David Schiff & Rosamund Ziegert eds. 2004) who deplors that most contemporary approaches lack "theoretical precision" and a "clear structure".

<sup>28</sup> GIBSON BURRELL & GARETH MORGAN, SOCIOLOGICAL PARADIGMS AND ORGANISATIONAL ANALYSIS: ELEMENTS OF THE SOCIOLOGY OF CORPORATE LIFE (1979).

gradual as opposed to revolutionary change and predominantly employ subjectivist, i.e. agent-centered, explanation models. This goes hand in hand with the use of *ideographic* research methods, i.e. an orientation towards qualitative rather than quantitative research.

The basic theoretical conceptions of evolutionary theory seem rather simple at first sight: Evolutionary theory argues that the starting point of every kind of change is the *variation* of the structural elements in question. Whether and to what extent variations have a sustaining impact on evolution depends on the second mechanism described by evolutionary theory: *selection*. Selection mechanisms differentiate between fitting and non-fitting variations with regard to the relevant environment. Variations which pass the fitness test are then preserved in a phase of *retention* or *stabilization*. This simplified account of evolutionary mechanisms raises two important questions. First, what is the relevant unit of description, i.e. what are the elements that are varied, selected, and stabilized? And, second, what is the relationship of the aforementioned mechanisms, i.e. are these processes connected by any causal logic? Both questions, however, are answered rather inconsistently in different strands of evolutionary theory.

## II. Legal Institutions and Economic Transactions

Valuable insights for our field of study related to the analysis of institutional change in international commerce can primarily be found in Evolutionary Economics.<sup>29</sup> Evolutionary Economics, starting from a principally actor-based approach, addresses the behavior of single economic agents as well as the resulting emergence of transactions and transaction types, institutions, and markets. Private agents on the one hand and public agents, i.e. the state or supra-/international organizations, on the other are defined as the starting point of any evolutionary process. Their respective choices directly influence the emergence and development of the institutions that govern commercial relations. The unit of analysis is thus defined as *institutional designs* or *norms*, understood broadly as patterns of behavioral expectations,<sup>30</sup> which are subject to the mechanisms of variation, selection and retention.

The issue at stake for private actors of international commerce is the resolution of cooperation problems.<sup>31</sup> In order to enter into exchange relationships, these actors

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<sup>29</sup> RICHARD R. NELSON & SYDNEY G. WINTER, AN EVOLUTIONARY THEORY OF ECONOMIC CHANGE (1982).

<sup>30</sup> For details see OKRUCH, *SUPRA* note 19) 47-51.

<sup>31</sup> WILLIAMSON, *SUPRA* note 7); OKRUCH, *SUPRA* note 19) 102-127.

must overcome their respective opportunism, as (boundedly rational) economic actors tend to "[destroy] part of the cooperation surplus to secure a larger share of it".<sup>32</sup> The possibility of opportunistic behavior, such as defection, leads to uncertainty of expectations, which is typically aggravated by the cross-border nature of the transaction.<sup>33</sup> The function of private governance mechanisms in international commerce is to eliminate opportunistic behavior and thus to enable and/or facilitate economic exchange. New Institutional Economics assumes that among different possible modes of governance (such as the market, the firm or hybrid forms of governance) private agents will design and choose those mechanisms that are most efficient in terms of transaction costs. Depending on the attributes of a specific transaction (asset specificity, uncertainty, frequency) certain governance mechanisms will prove more efficient than others and therefore be preferred.

Among the public agents of international commerce, the nation-state is particularly relevant. In the ambit of globalization, the nation-state is still responsible for the provision of legal institutions, although it has long lost its monopoly in this respect. As Kerber rightly points out, it is still primarily up to the nation-state to develop "regulatory law" in contrast to mere "facilitative law".<sup>34</sup> While regulatory law denotes mandatory norms laying down the "rules of the (market) game", facilitative law refers to all rules increasing the market's "capability to facilitate exchange or, more generally, voluntary cooperation".<sup>35</sup> Facilitative law can thus be effectively replaced by the norm-generating governance mechanisms employed by private regimes.<sup>36</sup> With regard to regulatory legislation, however, nation-states are forced into a regulatory competition as private agents make their investment decisions and choose their place of business according to the respective attractiveness of different regulatory environments. Inter- or supranational agents

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<sup>32</sup> Robert D. Cooter, *The Theory of Market Modernization of Law*, 16 INTERNATIONAL REVIEW OF LAW AND ECONOMICS 141, 145 (1996); OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 47 (1985) defines opportunism as "self-interest seeking with guile".

<sup>33</sup> KLAUS BACKHAUS, JOACHIM BÜSCHKEN AND MARKUS VOETH, INTERNATIONALES MARKETING (2001); Jörg Freiling, *Institutional Designs in International Transactions - An Evolutionary Economics Perspective* (2006), available at SSRN: [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1093271](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1093271), last accessed: 29 March 2008.

<sup>34</sup> See Wolfgang Kerber's contribution to this issue.

<sup>35</sup> Wolfgang Kerber & Viktor Vanberg, *Constitutional Aspects of Party Autonomy and Its Limits - The Perspective of Constitutional Economics*, in PARTY AUTONOMY AND THE ROLE OF INFORMATION IN THE INTERNAL MARKET 49 (Stefan Grundmann, Wolfgang Kerber & Stephen Weatherill eds., 2001).

<sup>36</sup> See generally Gunther Teubner, 'Global Bukowina': *Legal Pluralism in the World Society*, in GLOBAL LAW WITHOUT A STATE 3, (Gunther Teubner ed., 2006).

that might eliminate or at least ease this regulatory competition are hardly to be found on a global level.

An actor-centered explanation of institutional change in international commerce thus focuses on *choice* and *competition*. From the perspective of private actors, the variation, selection and retention of institutions take place in the following constellations:

- *Bilateral Private Governance*: Private agents use, modify, and develop governance designs in ‘repeated games’, e.g. supplier and customer interact and resolve cooperation problems without external pressure. Especially in long-term relationships where trust and commitment play a decisive role, typically no third-party participates in the coordination process. Relational norms, i.e. bilateral behavioral expectations, dominate the governance structure and the mix of institutional elements, which is very often complemented by (facilitative) state law.
- *Trilateral Private Governance*: The case (and history) of the law merchant (*lex mercatoria*) shows that norms might develop in a wider social context (e.g. an industry) as well. Codes of conduct and general principles of law can effectively reduce legal uncertainty without or with only little state intervention. The threat of reputation-losses in markets that are “value-sensitive” makes defective behavior unlikely. In addition, the common acknowledgement of arbitration panels facilitates the workability of such governance designs. Moreover, mega law firms in particular act as “legal entrepreneurs”<sup>37</sup> in international business, while the practice of institutional arbitration can also contribute to the emergence of a body of “transnational law”.<sup>38</sup>

That these governance mechanisms emerge and develop according to their competitiveness in terms of transaction costs, however, is only part of the story. It is obvious that the institutions of international commerce are, to a certain extent, *idiosyncratic*. These idiosyncrasies might be the result of actor-caused variation/selection/retention processes. But not only are the entities under scrutiny idiosyncratic, they also evolve in specific ways. They are embedded into specific environments that none of them face in the same way. These environmental

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<sup>37</sup> FABIAN SOSA, VERTRAG UND GESCHÄFTSBEZIEHUNG IM GRENZÜBERSCHREITENDEN WIRTSCHAFTSVERKEHR (2007).

<sup>38</sup> Peer Zumbansen, *Transnational Law*, in ENCYCLOPEDIA OF COMPARATIVE LAW, 738, (J. Smits ed., 2006); Graf-Peter Callies & Moritz Renner, *From Soft Law to Hard Code: The Juridification of Global Governance* (2007), available at SSRN: <http://ssrn.com/abstract=1030526>, last accessed: 17 March 2008.

conditions in addition to past decisions might effectively constrain the evolutionary path of the respective entity.

In management theory, this phenomenon has been discussed under the catchphrase of *increasing returns*. Increasing returns refer to the phenomenon of self-reinforcing developments based on certain triggers.<sup>39</sup> Whereas technological evolution shows us many examples of evolutionary lock-in based on network effects (e.g. the final adoption of the so-called QWERTY keyboard which proved to be ergonomically and economically inefficient), similar trends are possible in the institutional evolution of international business as well. However, the question as to the underlying factors of increasing returns is open. In this regard we can identify at least four driving forces:

- **Coordination:** In international business, the transaction partners interact so that bilateral adaptations take place. These adaptations facilitate interorganizational coordination by the development of common rules and routines. Both effectiveness and efficiency gains are the result.
- **Investments:** Sometimes closely connected with coordination considerations, the agents participating in the governance of international transactions make investments in certain governance modes. These investments create commitment since a shift to another mode would generate sunk costs. In trying to avoid these losses, actors stick to the initial solution and might trigger others to adopt it.
- **Power:** Powerful agents might exert certain pressures on other parties and make them follow the chosen path.
- **Learning effects:** The more agents get used to a certain governance design, the more knowledge develops which fosters effectiveness and efficiency gains as well.

As a consequence, increasing returns step by step create a certain path of institutional development. Although this is certainly not a one-way path, lock-in effects of more and more agents might occur, which makes self-reinforcing effects more likely. The result is a strong retention of certain governance modes in international business.

The concept of increasing returns thus helps us to understand that it is not necessarily the most efficient or effective solutions that will survive in competition.

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<sup>39</sup> Brian W. Arthur, *Competing Technologies, Increasing Returns, and Lock-in by Historical Events*, 99 ECONOMIC JOURNAL 116 (1989).

Instead, we have to analyze the historical development in connection with rigidities (e.g. by collective decision-making in institutions such as the state) and power relations. This debate has given rise to the impression voiced by Nelson and Winter that economic and social change is primarily a matter of establishing new or modified norms and rules because this way all the agents involved have at least some incremental discretion to provide the development with a certain sense of direction.<sup>40</sup>

From an economic perspective, institutional change is thus structured by the “twin ideas of spontaneous order and evolution” (F.A. von Hayek)<sup>41</sup>. Actors in international commercial transactions develop institutional solutions in response to coordination problems. These governance designs are *varied, selected* and *stabilized* depending on their competitiveness in terms of transaction-cost efficiency. This competition, however, is limited by path-dependencies that ultimately cannot be controlled by commercial actors. Institutional evolution, therefore, cannot be fully addressed by causal models of development that rely exclusively on an actor-based scheme of action and reaction.

### III. Evolution of Social Systems

The precarious relationship of spontaneous, competition-induced order and idiosyncratic, path-dependent evolution, however, can be further refined with the help of systems theory. This becomes especially apparent when we look at processes of “juridification”<sup>42</sup> in the institutional design of cross-border commerce. Most notably in international commercial arbitration, it can be observed that an increasingly autonomous legal discourse is emerging beyond the reach of the nation-state.<sup>43</sup> This observation alone seems rather surprising as the privatization of the governance of cross-border economic transactions has often been equated with a general demise of law.<sup>44</sup> The very idea of the *Alternative Dispute Resolution*

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<sup>40</sup> RICHARD R. NELSON AND SYDNEY G. WINTER, *AN EVOLUTIONARY THEORY OF ECONOMIC CHANGE* (1982).

<sup>41</sup> This expression is used by Friedrich A. von Hayek throughout his work, see e.g. *Notes on the Evolution of Systems of Rules of Conduct*, in ID., *STUDIES IN PHILOSOPHY, POLITICS, AND ECONOMICS*, 66, 77 (1967).

<sup>42</sup> See Gunther Teubner, *Juridification – Concepts, Aspects, Limits, Solutions*, in *JURIDIFICATION OF SOCIAL SPHERES* 3, 9 (Gunther Teubner ed., 1987).

<sup>43</sup> On the conceptual background of such developments see Ralf Michaels & Nils Jansen, *Private Law Beyond the State? Europeanization, Globalization, Privatization*, 54 *AMERICAN JOURNAL OF COMPARATIVE LAW* 843 (2006).

<sup>44</sup> See further, LUHMANN, *supra* note 27, 490, wondering whether the central role of law in European societies might be a mere “evolutionary anomaly”.

mechanisms relied upon by commercial actors is the settlement of disputes *without* recourse to the legal system. Nevertheless, global governance mechanisms often seem to oscillate between legal and non-legal modes of regulating individual behavior; private ordering, thus, is an issue not only for economics but for jurisprudence as well.<sup>45</sup>

In order to approach this matter from a legal (evolutionary) theory perspective, we can draw on Luhmann's distinction between the *performance* and the *function* of law, i.e. the services a legal system provides to other functional subsystems of society like the economy, politics, etc. on the one hand, and its relation to society as a whole on the other hand.<sup>46</sup>

The concept of performance ties in with the competition-oriented approaches outlined above. When legal institutions are analyzed as providing dispute resolution services and a certain level of behavioral control to the economic system, a host of functional equivalents to law comes into mind. In this respect, law stands in a performance competition to non-legal governance mechanisms.<sup>47</sup> Its ability to attract potential claimants, therefore, is a decisive factor in the development of any institutional design. In many cases, non-legal methods of dispute resolution are chosen by the parties for their superiority over state legal systems in terms of accessibility (standing), speed (rules of procedure), affordability, and – most importantly – attractiveness of remedies.<sup>48</sup>

The concept of function, in contrast, takes us back to the idiosyncrasies of institutional evolution. Systems theory, however, offers an outstanding conceptual framework for explaining these idiosyncrasies. Thereto, we must shift our analytical focus from the level of actors to the level of communication. In systems theory terminology, law is a communicative system that consists of all communications marked by the binary code legal/illegal. As such, it is a functional subsystem of society, which in turn is defined as the totality of all communications. In relation to society as a whole, law fulfils a unique function: "the stabilization of normative expectations", i.e. social expectations that are upheld even in cases of disappointment.<sup>49</sup> This function is what, on the one hand, distinguishes law from

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<sup>45</sup> Calliess/Renner, *supra* note 38.

<sup>46</sup> NIKLAS LUHMANN, DIE GESELLSCHAFT DER GESELLSCHAFT 757-8 (1998).

<sup>47</sup> Graf-Peter Calliess, *Billigkeit und effektiver Rechtsschutz. Zu Innovation und Evolution des (Zivil-) Rechts in der Globalisierung*, 26 ZEITSCHRIFT FÜR RECHTSOZIOLOGIE 35, 41 (2005) 41.

<sup>48</sup> *Id.*

<sup>49</sup> LUHMANN, *supra* note 27, 148.

every other social system and, on the other, determines the way in which legal communications are processed. Because "[i]f law has the function of stabilizing normative expectations in the face of an unorganized growth of normative expectations (...), this can be achieved only by a selection of those expectations that are worth protecting".<sup>50</sup>

The selection and stabilization of normative expectations, however, is not something that is necessarily bound to a *state* legal system. There is a growing literature debating the existence of a genuinely *transnational law*<sup>51</sup> emerging in the ambit of private governance.<sup>52</sup> At the point where, in the context of private governance regimes e.g. in the fora of international arbitration, conflicts are verbalized and processed with the help of an institutionalized memory,<sup>53</sup> we can observe an "evolutionary shift" from a state of institutional competition in terms of economic efficiency to a state of *autopoietic*<sup>54</sup> legal evolution. For the concept of autopoiesis implies an understanding of law that is based on the concept of recursivity: law both produces and is a product of legal communications. The stability of normative expectations is thus guaranteed by the 'operative closure' of law in a network of legal communications perpetually referencing other legal communications.<sup>55</sup>

In the context of the global economy, it is especially the customs of international trade as well as arbitral practice that contribute to the emergence of transnational legal norms and institutions by establishing a "logic of remembering and forgetting" which guarantees that certain behavioral expectations are "condensed and confirmed", while others fall into oblivion.<sup>56</sup> At this point the development of institutional structures is no more determined by a mere competition between governance mechanisms but begins to follow its own recursive logic – the logic of establishing the adequate complexity of a communicative system in relation to its social environment: "it is not economic efficiency but complexity that is the

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<sup>50</sup> *Id.*, 152.

<sup>51</sup> See Zumbansen, *supra* note 38.

<sup>52</sup> Perhaps most notably Teubner, *supra* note 36.

<sup>53</sup> For details see Calliess/Renner, *supra* note 38.

<sup>54</sup> LUHMANN, *supra* note 27, 81.

<sup>55</sup> *Id.*, 106 et seq.

<sup>56</sup> Graf-Peter Calliess, *Reflexive Transnational Law. The Privatisation of Civil Law and the Civilisation of Private Law*, 23 ZEITSCHRIFT FÜR RECHTSSOZIOLOGIE 185, 196 (2002).

intervening variable that translates evolutionary structural changes to adjustments within the system".<sup>57</sup>

When it comes to explaining the particulars of this recursive change of systemic structures over time, systems theory, too, relies on evolutionary models. Specifically, evolutionary theory is employed to explain "the conditions for possible unplanned changes of structure", "diversification" and the "increase in complexity" within social systems.<sup>58</sup> In this context, the mechanisms of variation, selection and stabilization are refined by putting them in relation to communicative systems. Variation is accordingly defined as referring to autopoietic *elements*, i.e., in the case of law, communications based on the binary code "legal/illegal". Selection, in contrast, is understood as referring to legal *structures*, i.e. norms. It is crucial to note, however, that the concept of norms/structures is not a static one, but structures merely represent a temporary state in the flux of legal communication.<sup>59</sup> The decisive evolutionary mechanism, then, is the maintenance of stability, which affects the *unity of the system*. This most difficult concept is defined as "dynamic stability, that is, continuation of the autopoietic, structurally determined reproduction in the changed form".<sup>60</sup>

While this modified version of evolutionary theory seems rather complex with regard to the units of description, its unassailable advantage is that – as a theory of change – it takes path dependencies seriously. Rather than being defined as a mere exception, path dependency is taken as the very starting point of any institutional development. This implies replacing unidirectional cause-effect explanations by a new paradigm of self-referential processes of change and accepting the possibility of autonomous institutional evolution. Of course, this still leaves open a number of questions. Specifically, it seems unclear to what extent autopoietic evolution still can be – and must be – influenced by its societal environment.

### C. Outlook and Perspectives for Research

These considerations have two distinct implications on our initial problem, the emergence and change of governance structures that provide legal certainty in international commercial transactions. As a first step, it seems necessary to combine

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<sup>57</sup> LUHMANN, *supra* note 27, 271.

<sup>58</sup> *Id.*, at 231.

<sup>59</sup> *Id.*, 84-5.

<sup>60</sup> *Id.*, 232.

the two complementary evolutionary perspectives of actor-based explanation models on the one hand and a theory of communicative systems on the other. By doing so, the valuable insights of (New) Institutional Economics can be taken as the basis for modeling the competition-induced “spontaneous” emergence of different governance designs. The explanatory gaps left open by this approach can be addressed by a theory of communicative systems that is based on recursive structural change. This will also allow us to gradually shift our analytical focus from institutional competition to explaining the change of the system-internal structures in the governance of international economic transactions.

As a second step, the evolution of private economic governance can then be put in relation to parallel or even asynchronous developments in different social discourses. Thereto, the research of institutional evolution must be complemented by an analysis of the *co-evolution* of social systems. Current research in our project, therefore, focuses on the internal as well as the external factors that influence the evolutionary path of transnational legal institutions. This includes the largely unanswered question of to what extent the transnationalization of governance structures is influenced by policy considerations. In systems theory terminology, the question is whether and how the development of transnational law is either “structurally coupled”<sup>61</sup> with a global political discourse or can be regarded as enabling constitutionalization processes in “autonomous sectors of world society”.<sup>62</sup>

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<sup>61</sup> For details on this concept see *Id.*, chapter 10.

<sup>62</sup> Gunther Teubner, *Global Private Regimes: Neo-spontaneous Law and Dual Constitution of Autonomous Sectors in World Society*, in GLOBALIZATION AND PUBLIC GOVERNANCE 71 (Gunther Teubner & Karl-Heinz Ladeur eds., 2004).