The Spontaneous Evolution of Commercial Law*

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I. Introduction

Jeremy Bentham contended that property and state-made law "are born and must die together. Before the [state's] law there was no property: take away the law, all property ceases" [4,309]. Most economists have taken this argument to heart. Clearly, some system of defining and then protecting and enforcing property rights (property law) and rules of exchange (contract law) is needed for a market system to develop. But does the state have to develop and enforce property and contract law? One purpose of the following presentation is to demonstrate that the commercial sector is completely capable of establishing and enforcing its own laws.

A second purpose is to illustrate that modern commercial law is, in fact, largely made by the merchant community despite governmental efforts to take over provision of such law. Commerce is an evolving process of interaction and reciprocity which is simultaneously facilitated by and leads to an evolving system of commercial law. Carl Menger [17] proposed that the origin, formulation and the ultimate process of all social institutions including law is essentially the same as the "spontaneous order" Adam Smith [20] described for markets. Markets guided by Smith's invisible hand coordinate interactions, and so does customary law [6; 7]. These systems develop because, perhaps through a process of trial and error, it is found that the actions they are intended to coordinate are performed more effectively under one institutional arrangement or process than under another. The more effective institutions and practices replace the less effective.

In the case of customary commercial law, traditions and practice evolve to produce the observed spontaneous order. As Hayek explained, however, while Smith's and Menger's insights are firmly established in economics, the study of jurisprudence has been almost completely unaffected by their arguments [9, 101]. One reason, of course, is that the invisible hand explanation for the emergence of market order is highly plausible because there is an obvious mechanism—the mechanics of individual but interrelated market prices—which provides the necessary coordination we call the price system. The mechanism of evolution for a legal order is much less obvious. Thus, the legal positivist view, which holds that law is the product of deliberate design, has a strong following among economists. Another major purpose of this discussion of commercial law, therefore, is to demonstrate that the rules of property and contract necessary for a market economy, which most economists and legal scholars feel must be "imposed," have evolved without the

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design of any absolute authority. Commerce and commercial law have developed coterminously, without the aid of and often despite the interferences of the coercive power of nation-states because there is a mechanism in place. Commercial law itself is analogous to the price system in that it facilitates interaction and makes exchange more efficient. The underlying mechanics are also analogous. Commercial law develops directly from the market exchange process as business practice and custom evolves.

In order to back up what may appear to be quite radical claims, the following presentation is divided into seven parts beyond this introduction. First, in section II below, the source of the authority of law is briefly explored and the mechanism for its production is introduced. Then section III contains an examination of the Medieval "Law Merchant" in light of the discussion of law and its evolutionary mechanism from section II. Merchants wanted to develop international trade in the tenth, eleventh and twelfth centuries but they were limited by the highly localized legal systems. Consequently, the international merchant community broke the bonds of localized political constraints to develop an international system of commercial law. They settled disputes in their own courts and backed their law with the threat of boycott sanctions. Section IV follows with an examination of the absorption of the Law Merchant by common law, while section V explores its reemergence as a primary force, particularly in American common law courts. Nongovernmental adjudication of commercial law today is discussed in section VI. The continuing evolution of privately produced commercial law is examined in section VII with emphasis on the international Law Merchant. Finally, concluding remarks appear in section VIII.

II. The Authority of Law

Lon Fuller explained that "Law is the enterprise of subjecting human conduct to the governance of rules" [6, 106]. Since law obviously requires an enforcement apparatus, Fuller's definition includes more than simply the existence of "social mores" defining rules of conduct. It is the enterprise of law which generates the mechanisms of recognition and enforcement, legal change, and dispute resolution. These mechanisms may take the now familiar form that we call government, but nation-states are not a prerequisite for law. We shall find that the merchant community's "enterprise" of accomplishing the subjection of commercial conduct to control naturally generated mechanisms for recognition, adjudication, and change.[1]

One particular aspect of the enterprise of law requires discussion. Legal positivists typically contend that for law to be recognized, it must be backed by some absolute authority which cannot be withdrawn even when that authority is abused. This clearly implies coercive state power. In fact, however, while authority may appear to be vested in individuals (leaders) or institutions (legislatures, courts), this appearance is a manifestation of the actual source of legal authority. As Hayek explained, those who appear to have authority to settle issues of law need not actually determine whether certain actions have abused the will of the state, but "whether their actions have conformed to expectations which other parties had reasonably formed because they corresponded to the practices on which the every day conduct of the members of the group was based" [10, 97]. Custom and practice gives rise to expectations which in turn guide people's action, so those practices that people have come to count on observing are what often are recognized as law.

1. This terminology corresponds to Hart's [8] concepts of primary and secondary rules, but the interpretation differs somewhat [3].

Authority of (or support for) a legal system ultimately derives from a feeling that it is "right" because it verifies expectations [6, 138].

Under this view of authority it becomes clear that reciprocal arrangements are the basic source of the recognition of duty to obey law [5] (and of law enforcement when state coercion does not exist [3]). Fuller suggested three conditions which make a legal (or moral) duty clear and acceptable to those affected:

> *First,* the relationship of reciprocity out of which the duty arises must result from a voluntary agreement between the parties immediately affected; they themselves "create" the duty. *Second,* the reciprocal performances of the parties must in some sense be equal in value . . . We cannot here speak of an exact identity, for it makes no sense at all to exchange, say, a book or idea in return for exactly the same book or idea. The bond of reciprocity unites men, not simply in spite of their differences but because of their differences. When, therefore, we seek equality in a relation of reciprocity what we require is some measure of value that can be applied to things that are different in kind. *Third,* the relationships within the society must be sufficiently fluid so that the same duty you owe me today, I may owe you tomorrow—in other words, the relationship of duty must in theory and in practice be reversible . . .
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> These, then are the three conditions for an optimum realization of the notion of duty; the conditions that make a duty most understandable and most palatable to the man who owes it [6, 23–24].

The authority which can most effectively back law is individual realization of reciprocal benefits arising from recognition of that law. Indeed, Fuller proposed that "customary law" might best be described as a "language of interaction" [7, 213]. Now let us turn to the development of the medieval Law Merchant to illustrate that reciprocal gains from recognition of rules of property and contract provided sufficient incentives for merchants to establish their own stateless enterprise of law.

III. The Medieval Law Merchant: Voluntarily Produced Law for the Commercial Revolution

With the fall of the Roman Empire, commercial activities in Europe were almost nonexistent relative to what had occurred before and what would come after. Things began to change in the eleventh and twelfth centuries. Rapid expansion in agricultural productivity meant that less labor was needed to produce sufficient food and clothing to sustain the population. Agricultural commodities were produced at levels which stimulated greater trade and population began to move into towns, many of which rapidly became cities of substantial size [5, 333–335].

One consequence of (and simultaneously, one impetus for) the increased productivity in agriculture and the urbanization which followed was the emergence of a class of professional merchants. There were significant barriers to overcome before substantial interregional and international trade could develop, however. Merchants spoke different languages and had different cultural backgrounds. Beyond that, geographic distances frequently prevented direct communication, let alone the building of strong interpersonal bonds that would facilitate trust. Numerous middlemen were often required to bring about an exchange, including buyer, seller and shipping agents. All of this, in the face of localized, often contradictory laws and business practices, produced hostility towards foreign commercial customs and led to mercantile confrontations [23, 11]. There was a clear need for Law as a "language of interaction."

It was during this period, because of the need for uniform laws of commerce to facilitate international trade, ". . . that the basic concepts and institutions of modern Western mercantile law—*lex mercatoria* ("The Law Merchant")—were formed, and, even more important, it was then that mercantile law in the West first came to be viewed as an integrated, developing system, a body of law" [5, 333]. Virtually every aspect of commercial transactions in all of Europe (and in cases even outside Europe) were "governed" by this body of law after the eleventh century. In fact, the commercial revolution of the eleventh through the fifteenth century that ultimately led to the Renaissance and industrial revolution, could not have occurred without the rapid development of this system of law. This body of law was voluntarily produced, voluntarily adjudicated and voluntarily enforced. In fact, it had to be. There was no other potential source of such law, including state coercion [23, 13].

Recognition

Recall Fuller's three conditions for reciprocity providing "optimal efficacy of the notion of duty." Fuller also noted that the kind of society in which these conditions are most likely to be met "is a surprising one: in a society of economic traders" [6, 24]. Traders enter into voluntary exchange. The market determines the value of disparate goods so that "equal" exchanges are possible. Of course, without market determined prices the concept of equality in value has little substance. Furthermore, traders frequently change roles as buyers and sellers so that the duties which arise out of exchanges are reversible. Indeed, such analysis led Fuller to conclude that it is only under capitalism that legal duty can become fully developed [6, 24].

The Law Merchant did not spring from a void. A considerable part of it was based on Roman commercial law [5, 339]. Nonetheless, Roman law as it was passed down through the centuries was not adequate to meet the kinds of problems that arose in the early commercial revolution.[2] Furthermore, none of the other systems of law that existed or were being formulated during this period were sufficient to meet the needs of the merchant class either.[3] The development of commercial law was almost entirely left up to the merchants themselves. This meant that the Law Merchant was customary law, and the "customary nature of the Law Merchant was by far the most decisive factor in its development: it made the law eminently a practical law adapting to the requirements of commerce" [6, 12]. When new forms of commercial activity developed, evolving business practice framed the new law. The emergence of the commercial society was spontaneous and undesigned. Its development on an international level required simultaneous and complementary evolution of the mechanics of market exchange and of commercial law.

When the merchant class began to develop in various localities, localized business practices (customs) also developed. International trade required that major conflicts between local customs be eliminated. The international Law Merchant evolved just as Hayek suggested customary law in general evolves: "transmission of rules of conduct takes place from individual to individual, while what may be called the natural selection of rules will operate on the basis of the greater or lesser efficiency of the resulting order of the group" [9, 67]. As merchants began to transact business across political, cultural and geographic boundaries they transported trade practices to

2. Roman commercial law was not state produced [15, 83]. Indeed, customary law has been the source of the rules of trade and commerce throughout history [23, 7–8].

3. Several systems of law arose around the same time, including the royal law of many countries (e.g., common law) [5].

foreign markets. Those previously localized customs which were discovered to be common to many localities became part of the international Law Merchant. Furthermore, where conflicts arose, those practices which proved to be the most efficient at facilitating commercial interaction supplanted those which were less efficient [23, 11]. As international trade developed, the benefits from uniform rules and uniform application of those rules superseded the benefits of discriminatory rules and rulings that might favor a few local individuals. By the twelfth century, commercial law had developed to a level where alien merchants had substantial protection in disputes with local merchants, and ". . . against the vagaries of local laws and customs" [5, 342].[4]

The universality of the Law Merchant was more than just a result of the commercial revolution. It was a prerequisite for the rapid development of trade. Without clear and understandable laws, alien merchants would not have been willing to carry on trade at near the level that arose during the eleventh, twelfth and subsequent centuries. Merchants required protection against potential discrimination by locally enforced laws, and protection from the potential abuses of coercive states that were increasing their law making and law enforcement powers during the same period [5, 343].

Landes and Posner noted that

> . . . there would appear to be tremendous economies of standardization in [law], akin to those that have given us standard dimensions for electrical sockets and railroad gauges. While many industries have achieved standardization without monopoly, it is unclear how the requisite standardization of commonalty could be achieved in the [law] without a single source for [law]—without, that is to say, a monopoly . . . [13, 239].

Many have concluded that the state must be that monopoly source of law. This clearly is not the case, however.[5] Indeed, such significant economies of standardization exist in commercial law that it took the voluntarily produced and adjudicated Law Merchant to overcome the limitations of political boundaries and localized protectionism.

Rules of Obligation

The laws which came to dominate the international Law Merchant were laws which reinforced rather than superseded business practice: laws which commanded merchants to do what they had already agreed to do [23, 10]. Furthermore, these laws typically did not involve complex legal forms or mandatory controls over business. Commercial law was clearly intended to be a language of interaction. Complexities that might hinder communication and thereby inhibit trade were avoided.

Commercial law can be conceived of as coordinating the self-interested actions of merchants, but perhaps an equally valuable insight is gained by viewing it as coordinating the actions of people with limited knowledge and trust. The need for a language of interaction then becomes more apparent. The limitations of knowledge in emerging medieval commerce are obvious, of course. Thousands of traders traveled to fairs and markets all over Europe exchanging goods

4. Some differences remained across various localities, but this does not imply that the legal system was inefficient or a reflection of local discriminatory practices. Indeed, the remaining diversity reflected differential preferences for relatively minor variations in commercial practices and institutions among the merchant groups who tended to travel to the various markets and fairs, thus enhancing the universal recognition of developing commercial law [23, 20–21].

5. There is no reason to believe that any particular national government is of the ideal size to take full advantage of the economies of standardization in law. In fact, economics of standardization really provides a justification for voluntarily produced law, in order to break away from the inefficient artificial political restrictions that exist [3].

which they knew little about with people they knew little about. Exchange itself allows individuals to take advantage of different producers' specialized knowledge. Markets coordinate diffused knowledge [10, 13], but diffused knowledge necessarily implies that some people are ignorant of what others know and commercial law evolved as international commerce developed in the middle ages, in order to keep commercial transactions as simple as possible. In the process, over the period from 1000 to 1200 the rights and obligations of merchants in their dealings with each other became significantly more objective and precise, and less arbitrary [5, 341].

Furthermore, as the norms of commercial law became more precisely specified they were increasingly recorded in writing. These written laws were not statutory codes, although many governments ultimately did adopt the Law Merchant in their commercial legislation, as noted below. Rather, they were written commercial instruments and contracts [5, 439]. In this regard, note that "contract law" refers to the "law" parties in exchange bring into existence by their contractual agreement rather than to the law of or about contracts. Thus, customary law and contract law are closely linked [7, 224–225].[6] As a contractual form came into common usage it actually became part of the Law Merchant.

When it is recognized that individuals had to voluntarily adopt a certain practice (enter into a contract) before it could develop as common usage it becomes clear why the Law Merchant had to be objective and impartial. Reciprocity, in the sense of mutual benefits and costs, is the very essence of trade. However, the legal principle of reciprocity of rights, as it was developed in the late eleventh and early twelfth centuries and still is understood today, involves more than mutual exchange. It involves an element of fairness of exchange. Thus, mercantile law required that exchanges had to be entered into "fairly" [16, 16; 23, 12]. Fraud, duress or other abuses of the will or knowledge of either party in an exchange meant that the transaction would be invalidated in a merchant court. Beyond this however, "substantively, even an exchange which is entered into willingly and knowingly must not impose on either side costs that are excessively disproportionate to the benefits to be obtained; nor may such exchange be unduly disadvantageous to third parties or to society generally" [5, 343]. Fairness was a required feature of the Law Merchant, of course, precisely because its "authority" arose voluntarily from recognition of reciprocal benefits. No one would voluntarily recognize a legal system that was not expected to treat him fairly. The objectivity and impartiality of the Law Merchant, reflecting this emphasis on fairness, was further reinforced by impartial adjudication which manifested itself in the rise of participatory merchant courts.

Adjudication

The Law Merchant "governed" without the coercive power of a state. Merchants formed their own courts to adjudicate disputes in accordance with their own laws. These courts' decisions were accepted by winners and losers alike because they were backed by the threat of ostracism by the merchant community at large [23, 10]—a very effective boycott sanction. A merchant who broke an agreement or refused to accept a court ruling would not be a merchant for long because his fellow merchants ultimately controlled his goods. The threat of a boycott of all future trade "proved, if anything more effective than physical coercion" [24, 96].

Merchants established their own courts for several reasons. For one thing, state law differed from merchant law. For instance, the royal courts of the day typically would not consider dis-

6. Customary law and contract law are typically differentiated much more sharply than suggested here. However, Fuller argued quite forcefully that a sharp distinction is inappropriate [7, 176].

putes arising from contracts made in another nation. And government courts would not honor any contractual agreement which involved the payment of interest. Any interest was usurious. Common-law courts would not consider books of account as evidence despite the fact that merchants held such records in high regard. Merchants needed their own courts in order to enforce their own law.

Another reason for the development of merchant courts was that resolutions of commercial disputes often had to be achieved after consideration of highly technical issues. In such cases, the merchant courts used judges who were experts in that particular area of commerce, unlike royal court judges who could adjudicate disputes about which they knew nothing. Merchant court judges were always merchants chosen from the relevant merchant community (fair or market). It was widely recognized that lawyers were not suitable judges in commercial matters for a number of reasons [23, 15]. For instance, lawyers lacked knowledge of commercial custom and practice. Furthermore, they tended to be preoccupied with strict rules that involved formalities which often hindered commerce. Commerce, and simplicity in its law were paramount.

Perhaps the most widely cited characteristic of the merchant courts was their speed and informality [5, 347]. This characteristic was in response to the needs of merchants, of course, and a third reason for developing merchant courts [16, 13]. Merchants of the time had to complete their transactions in one market or fair and quickly move to the next. A dispute had to be settled swiftly to minimize disruption of business affairs. This speed and informality could not have been equitably achieved without the use of judges who were highly knowledgeable of commercial issues and concerns, and whose judgments would be respected by the merchant community at large. Participatory or communal adjudication was, therefore, a necessary characteristic of the Law Merchant. The adjudicative procedures, institutional devices and substantive legal rules adopted by merchant courts all reflected the overall concern for facilitating commercial interaction.

In this same light, rules of evidence and procedures were kept simple and informal. Appeals were forbidden because the tribunals wished to avoid unnecessary litigation and delays in order to avoid disruptions of commerce [23, 16]. Similarly, there was an avoidance of lengthy testimony under oath; notarial attestation was usually not required as evidence of an agreement; debts were recognized as freely transferable through informal "written obligatory," a process developed by merchants themselves to simplify the transfer of debt; actions by agents in transactions were considered valid without formal authority; and ownership transfers were recognized without physical delivery [23, 14]. All these legal innovations were validated in merchant courts despite their frequent illegality in national courts. All were desirable because they promoted speed and informality in commerce and reduced transaction costs. In fact, this brings up a fourth reason for developing participatory merchant courts. While royal law, such as the common law in England, was developing during this same period, and while supporters of the common law take pride in its rationality and progressiveness, the fact is that this state produced law as enforced by the kings' courts simply did not adapt and change as fast as the rapidly changing commercial system required.

Change

Considerable change in the Law Merchant occurred in a relatively short time. In fact, Berman found that "a great many if not most of the structural elements of the modern system of commercial law were formed in this period" [5, 350]. Consider, for example, the development of credit devices. By the twelfth century, barter trade had been virtually replaced by commercial middlemen who bought and sold using commercial contracts involving credit. The main forms

of credit extended by sellers to buyers were promissory notes and bills of exchange. When such commercial instruments became common, they acquired the character of independent obligations, like money; they also became negotiable, another characteristic of money [5, 350]. The practice of negotiability of credit instruments did not exist prior to this period; it was "invented" by Western merchants because of the need for improved means of exchange as commerce developed, and because the rise of the Law Merchant generated sufficient confidence in the commercial system so that a reservoir of commercial credit could be established [5, 351].

Credit instruments became the means of exchange that allowed trade to flourish and the commercial revolution to take place. The Roman commercial system had functioned because of the availability of money issued by Rome, but with the fall of Rome a currency that could be trusted to maintain its value disappeared, and so, virtually, did commercial trade. No sound source of money as a means of exchange arose, so in order for trade to emerge again, merchants had to develop their own exchange medium. "The take-off of the following period was fueled not by a massive input of cash, but by a closer collaboration of people using credit" [5, 351]. In other words, when government could not be counted on to provide a stable means of exchange, the merchant community provided its own through a series of legal innovations.

Many kinds of credit instruments developed during the period, and all became part of the Law Merchant. As Hayek explained, even though order developed "spontaneously because the individuals followed rules which had not been deliberately made but had arisen spontaneously, people gradually learned to improve those rules" [10, 45]. Thus, for instance, credit was extended from sellers to buyers in the form of the negotiable instruments mentioned above. Buyers extended credit to sellers through the use of various contracts for future delivery of goods. Third parties (e.g., bankers) extended credit to buyers, and in order to protect these creditors against default, devices such as mortgages of movables were developed. These were all new legal devices developed during this period.

Many other aspects of the Law Merchant could be examined to emphasize the evolution and integration of a wide variety of principles, concepts, rules and procedures into a system of law.[7] They shall not be discussed, however, because the story would, in each instance, be similar to the development of commercial credit devices. The point is that government institutions are not needed for a complex system of commercial law to arise. Rules can be formulated and then rapidly spread among large diverse groups when changes prove desirable. Duty to those rules can be recognized as a consequence of the reciprocal arrangements that are reflected in contract and exchange. Adjudication procedures and ostracism sanctions can be developed to facilitate compliance to those rules. The medieval Law Merchant proves this. In fact, the Law Merchant is still in place today, providing the law needed to carry out international trade, as explained below. Beyond that, the customary law developed by the Law Merchant has been absorbed in whole or in part by the common law and civil law systems of Western Europe and America, thus providing substantial components of the underpinnings of today's domestic commercial law. The process and consequences of that absorption are explored next.

IV. The Absorption of the Law Merchant into Common Law

Beginning around the twelfth century, governments in Europe began systematically "enacting" the customary rules established by the Law Merchant [5, 341]. England was no exception with

7. See [5, 349–50] for a list of legal innovations in the Law Merchant during the eleventh and twelfth centuries.

codification of the *Carta Mercatoria* in the fourteenth century. Such enactments were not new law. Established custom still provided the rules of commerce, so even where a government legislated, the rules that had already been established by merchants were simply confirmed or slightly modified [16, 11].

Merchants continued to use their own courts despite state codification of commercial law, so governments also began to make laws which would attract merchants into the royal courts and/or make merchant courts less desirable. In England, for example, the Statute of the Staples of 1353 presumably gave "merchant strangers" protection in the fourteen major trading centers for "staple" products—mainly wool, leather and lead. Trade in these goods was handled primarily by Italian, Flemish and German merchants and bankers. Of course, such protection already existed under the Law Merchant so this was largely a codification of custom. Similarly, the statute specified that disputes involving these foreign merchants would be settled under the Law Merchant, rather than royal law or any law of the city which might apply. Significantly, however, appeals could be taken to the chancellor and the King's council. By giving merchants access to royal appeal the appearance of royal enforcement of commercial law was created, while simultaneously a roll for the royal courts in enforcement of commercial law was established. And perhaps more importantly, by creating the possibility of appeal, the authority of the merchant courts and the Law Merchant itself was weakened. The potential for appeal made the Law Merchant appear to be less decisive law. Thus, through a gradual process of absorption by creating governmentally backed institutional arrangements and laws which would be acceptable to the merchants, and by weakening the authority of the merchant courts, commercial law began to become part of common law. In fact, common law institutions were relatively more acceptable because the authority of Law Merchant institutions was undermined.

The Statute of Staples also began a process of focusing and concentrating foreign trade flows so they would be easier to control by the state. Most foreign trade was compelled to pass through a few important towns in the fourteenth century, and special courts were created in these "staple" towns to administer the Law Merchant [16, 72]. The makeup of these courts was dictated to consist of the mayor of the town, two constables and two merchants. It was only from these staple courts that appeal could occur. Fairs and markets still held their own merchant courts, however.

Competition between Courts

Several competing court systems existed in England prior to the seventeenth century. Separate royal common law courts (e.g., Common Pleas, King's Bench, Exchequer) [3], the cannon law courts [5], the royal maritime courts [16, 57–77], and the merchant courts, among others [3], were all in competition with one another for various parts of the dispute resolution business. The common law courts ultimately triumphed over most of the competition, however. The method of victory was similar in each instance, so the emphasis below is on the competition between the common law and merchant courts, but it must be stressed that other courts also actively pursued commercial disputes [3].

Merchant courts remained available for commercial disputes up until the early 1600s, although case loads were gradually shifted into government courts. Landes and Posner suggested that the royal courts worked to gradually take more and more cases away from the merchant courts, because it was in the financial self-interest of the English judge, who was paid, in large part, out of litigation fees during this period [13, 258]. This probably added incentives to governmental efforts to absorb the Law Merchant. Furthermore, since the merchants really remained free to choose between their own courts and the royal courts through the fifteenth and sixteenth centuries,

the fact that merchants were willing to choose the royal courts in increasing numbers implies that those courts must have been doing a reasonably good job of applying the Law Merchant. The threat of competition from private merchant courts was always there, so if the royal courts wanted the merchants' business they had to enforce law as the merchants saw fit.[8] Of course, the royal courts had some advantage in this competition due to state actions such as those discussed above which weakened the authority of the merchant courts and enhanced that of royal courts.

The competitive relationship between royal and merchant courts was altered substantially in 1606, with an even greater advantage going to the royal courts. The dictum pronounced by Lord Edward Coke in reviewing a case previously judged under private arbitration was "that though one may be bound to stand to the arbitrament yet he may countermand the arbitrator . . . as a man cannot by his own act make such an authority power or warrant not countermandable which by law and its own proper nature is countermandable" (Quoted in [14, 18]). This ruling meant that the decisions of the merchant courts could be reversed by the royal courts, because an arbitrator's purpose was, according to Coke, to find a suitable compromise, while a judge's purpose was to rule on the merits of the case. In essence, Coke's ruling asserted that the Law Merchant was not a separate identifiable system of law, but rather that it was "part of the law of the realm." This was in turn interpreted to mean that merchants were bound to submit to the jurisdiction of the common law courts and subject to those courts' procedures. In effect, it withdrew the guarantee in the Statute of Staples that merchant disputes would be settled according to the Law Merchant rather than royal law. The use of private commercial courts virtually disappeared in England after the early 1600s. Now let us consider the consequences of this takeover on the application and growth of commercial law.

The Subjugated Law Merchant

The Law Merchant did not die. It changed in the seventeenth century, becoming less universal and more localized under state influence; it began to reflect the policies, interests and procedures of kings. Merchant custom remained the underlying source of much of commercial law in Europe, and to a lesser degree in England, but it differed from place to place. "National states inevitably required that their indigenous policies and concerns be given direct consideration in the regulation of commerce. As a result, distinctly domestic systems of law evolved as the official regulators of both domestic and international business" [23, 24].

The changes were most striking in England where the courts rejected many of the underpinnings of the Law Merchant after Coke's 1606 ruling [23, 26–27]. Merchants became increasingly constrained under the common law system as the informal, speedy institutions they had developed disappeared for well over two centuries. Furthermore, English common law courts either refused to admit custom into law, or custom was required to satisfy onerous admissibility tests. In particular, the origins of a business practice had to be demonstrated to be truly "ancient" and the practice had to be consistently employed for a long period in order for it to be considered as law —this despite a rapidly changing business environment. Thus, English common law restricted the

8. The gradual shift of merchant cases to government courts might suggest that government courts were providing and enforcing a "better" law than the Law Merchant. Certainly the voluntary shift implies that merchants found it in their own self-interest to use government courts. However, note that not all litigation and enforcement costs were covered by fees; taxpayers were subsidizing some aspects of government law enforcement. The relevant self-interest motive actually appears to be that merchants were able to shift part of the cost of adjudicating and enforcing their law onto others, not that government courts provided better law [3]. In addition, of course, the merchant courts' authority was being reduced through the creation of royal court appeal procedures.

evolution and use of business practice as a source of commercial law. "In this way, the Law Merchant became rigid as post-medieval English judges sought to integrate the Law Merchant into the established confines of a centralized common law" [23, 27]. Many of the desirable characteristics of the Law Merchant in England had been lost by the nineteenth century, including its universal character, its flexibility and dynamic ability to grow, its informality and speed, and its reliance on commercial custom and practice.

Still, the Law Merchant could not be completely eliminated for a very good reason. Custom prevailed in international trade, and England was a great trading nation. English judges had to compete with other national courts for the attention of international merchants' disputes so they had to recognize commercial custom in cases involving international trade if they hoped to attract such cases. One important reason for this, in the context of such competition, was that the European countries' civil law had been much more receptive to the Law Merchant than had English common law [23, 24]. There was some fragmentation in the form of the Law Merchant across Europe, but there was little difference in its substance.

V. The Reemergence of the Law Merchant in Common Law

Some legal historians cite Lord Mansfield as the "founder of commercial law" in England, but in fact, Mansfield simply reintroduced the international Law Merchant into English law [23, 27]. Mansfield argued quite forcefully that England's commercial law had to develop as business practice developed, and had to recognize business custom and usage. The primary impetus for once again recognizing the merchants' law, however, may have been the fact that the common law courts' hold on commercial law once again came under significant competitive threat at about this time. International competition by national courts for the attention of merchants was apparently getting more intense [23, 27]. As England's relative position in world trade began to decline, common law courts began to lose international business disputes to other nations' courts. There was a new source of competition as well.

The modern resurgence of commercial arbitration can be traced to the American Civil War. The naval blockade of the South resulted in tremendous court congestion in England due to contract claims—claims that would have taken years to untangle [24, 99]. The contracts were in regard to the purchase, delivery and sale of cotton to British markets. Many ship owners became unwilling to run the blockade, and a lot of those who tried had their vessels sunk. Further complications arose due to British neutrality, and contraband-of-war laws. Insurance was either unavailable, or carried new and extremely complex provisions developed in light of the tremendous uncertainty. These provisions required reinterpretation with each new contingency. Because of all the difficulties and uncertainties associated with the blockade, and the resulting public court backlog, the Liverpool Cotton Association, whose members were handling most of the cotton trade, agreed to insert arbitration clauses in their contracts. Arbitration proved to be very inexpensive and convenient relative to public court adjudication, as well as less disruptive to business arrangements (the adversarial nature of public law suits tended to terminate profitable business relationships while the compromising character of arbitration tended to preserve them), so other Liverpool commercial associations quickly adopted the device [24, 99].

The success of arbitration in Liverpool led to its adoption in London within a short period of time. The large commodity dealers (corn, oil seed, cotton and coffee) established arbitration clauses first, followed by stock dealers and produce merchants. Then professional associations

of architects, engineers, estate agents and auctioneers took up the practice, regularly putting arbitration clauses in all contracts to guarantee that disputes over transactions would not go into government courts. The benefits of arbitration were quickly recognized despite Coke's 1606 ruling.

The long period of subjugation was not without its costs, however. After the common law court system gained control of the market for disputes, it began acting like a coercive monopolist, dictating or administering law rather than recognizing the more important source of law—evolving business practice. Consequently, as common law developed through judicial precedent, the evolution of merchant custom and practice was altered from what it might have been without such coercive influence. "The Law Merchant, rather than influencing the growth of common law, has often been influenced—indeed changed in character—by the common law. Customs of the Law Merchant which were adopted in the early common law have sometimes been so rigidified in legal content that they have varied from their merchant origins" [23, 30]. The rigid definition of custom and requirement that it be consistent with the state's law remained integral parts of British common law as applied to commercial disputes and British merchants became accustomed to operating under common law rigidities.

The American Law Merchant

Merchants brought their law to colonial America and quickly moved to establish their own systems of rules and dispute resolution even as common law was subjugating the Law Merchant and its courts in England. Commercial law and its enforcement were dominated by custom and private arbitration in North America through the eighteenth century. Merchants avoided government courts because those tribunals did not apply commercial law in a just, and inexpensive fashion. Furthermore, public courts did not accept new commercial practices rapidly enough. Indeed, it was not until the end of the eighteenth century that public judges began to convince merchants that they could understand complex business issues and practices, and that they accepted as law, agreements established to facilitate the reciprocal self-interest motives of traders. Once the government courts began to apply the merchants' law as the merchants had established it, without delay, the commercial arbitration system began to disappear [1, 33].

Public judges in America have been somewhat more receptive of the Law Merchant than their English counterparts [23, 33]. Indeed, the Uniform Commercial Code indicates that business practices and customs have served as the primary source of substantive business law, as "the positive law of the realm was forced to conform to the mandate of the merchants, not vice versa" [23, 34]. This probably reflects the widespread acceptance of commercial arbitration prior to 1800 (and its revitalization since 1900, as discussed below). In addition, many litigants can choose among different jurisdictions. Two or more state court systems might have jurisdictional claims over a case, for example, or perhaps both state and federal courts can be considered. With the jurisdictional divisions that exist in the United States, competition for disputes may be much more significant than in England.

Trakman suggested the possibility that the uniformity of commercial law might be undermined because of separate state court systems and regional specific federal court jurisdictions in the United States, if local custom supersedes more uniform national or international business practices [23, 34–35]. The potential for the same kind of breakdown in the universality of the law merchant that occurred with the rising power of kings and their royal law may be present in the United States. In fact, however, substantial differences in business practices across local

American communities are rare. This is really not too surprising. If judges were only interested in monopolizing local business disputes, state precedent might differ significantly, but given the open nature of the U.S. economy, interstate competition for business disputes is likely to reduce the tendency for favoring local businessmen and their customs. Furthermore, commercial arbitration has reemerged as a viable option for business disputes and its competitive impact has been substantial.

The potential for arbitration as an alternative to public courts always existed in the United States, forcing public courts who sought to adjudicate commercial disputes to dispense law as the merchant community had developed it. Thus, the reemergence of commercial arbitration in the United States around the end of the nineteenth century is not surprising. As government regulation became more intrusive, businessmen re-established arbitration to maintain their voluntary exchanges without state interference. Arbitration was seen as a "shield against government intrusion" [1, 101]. The New York Chamber of Commerce's arbitration committee evolved into a permanent tribunal just before the end of the nineteenth century. The main area of rapid arbitration redevelopment was in the trade associations, however. By the end of World War I, arbitration had become the preferred practice among many of these groups. However, the character of the reemergence of arbitration has been strongly influenced by the threat posed by the coercive power of the government courts.

VI. Non-Governmental Adjudication of Commercial Law Today

The practice of commercial arbitration in the United States has continued to grow since its reemergence at the beginning of this century. It has been estimated that almost 75 percent of commercial disputes were being settled through arbitration by the 1950s [1, 113], and that the use of commercial arbitration was increasing at the rate of about 10 percent per year in 1965 [14, 20]. This trend appears to be continuing although data on the extent of commercial arbitration is not available. Many industries and most trade associations now insert arbitration clauses into all their contracts.

Non-merchant Influences on the Evolution of Arbitration

When arbitration reemerged in the United States, support came from a surprising source. Influential lawyers proposed that voluntary arbitration by a lawyer should be used to alleviate court congestion and delay. This was not just a public spirited effort to relieve court congestion, however. Auerback explained that lawyers felt that if only lawyers with "character and learning" served as arbitrators, "suspicion and reproach" of the bar would diminish [1, 104]. Another factor not stressed by Auerback was that lawyers were beginning to recognize the competitive threat that commercial arbitration posed to the government's adversarial dispute resolution process which they had come to dominate [3]. They hoped to dominate arbitration as well [1, 104]. In contrast, businessmen wanted speedy, inexpensive dispute resolution based on business custom and practice—they wanted the Law Merchant—but when the New York Bar made a strong lobbying effort to obtain state recognition of arbitration's "legality" it was supported by the Chamber of Commerce. This led to a 1920 New York statute presumably designed to overturn the 1606 common law ruling by Lord Coke. Arbitration agreements were made binding under New York law and enforceable in New York courts. Since then all the other states have passed similar statutes.

Many observers of the legal process contend that arbitration clauses in contracts are "effective, in a major part anyway only because the public courts enforce such contracts; if they did not,

there would often be no effective sanction against the party who simply breaches the contract to arbitrate" [13, 247]. In other words, private arbitration is a viable option to public courts because it is backed by those public courts. This claim is demonstrably false. For one thing, the historic development of the Law Merchant indicates that a significant boycott sanction can be produced by the commercial community. Indeed, it is explained below that the international Law Merchant survives and flourishes to this day without the backing of a coercive government authority. Beyond that, arbitration caught on and developed in the United States before 1920—that is, before an arbitrator's award could be taken into a public court—indicating that legal coercion is not essential for its success. The boycott sanction can still work. A merchant refusing to abide by an arbitration ruling before 1920 would find future access to his trade association's arbitration tribunal withdrawn or see his name released to the association membership: "these penalties were far more fearsome than the cost of the award with which he disagreed. Voluntary and private adjudications were voluntarily and privately adhered to if not out of honor, out of self interest" [24, 101]. This does not mean that the New York statute and all those which followed have not had an impact on arbitration, however. In fact, arbitration became a less attractive alternative to the public courts than it would have been in the absence of these laws. These statutes did what the availability of royal appeal did centuries earlier—they undermined the authority of the merchant community's own courts.

Lawyers became actively involved in commercial arbitration because of these statutes. An enormous number of court cases were filed after passage of the New York statute, for instance, as businessmen tried to determine what characteristics of arbitration would be considered "legal" by the courts. Cases involved such issues as the appropriate way to select arbitrators, whether lawyers had to be present, whether stenographic notes of the proceedings should be taken, and so on. Businessmen, forced to pay attention to the prospect of judicial review, had to make their arbitration processes compatible with statute and precedent law including procedural aspects of common law. One observer of the period following 1920 noted that "There is irony in the fate of one who takes precautions to avoid litigation by submitting to arbitration, and who, as a reward for his pain, finds himself in court fighting not on the merits of his case but on the merits of arbitration . . . [this] monumental tragicomedy [demonstrates the success of the government legal process at] thwarting legitimate efforts to escape its tortuous procedure" [11, 149–151].

Commercial arbitration has continued to face legal establishment attacks since the 1920s, but the public courts with their long, expensive delays simply are no longer competitive with merchant courts for the large majority of commercial disputes. Even though the character of arbitration has been substantially influenced by the efforts of government to limit its authority and make it less attractive, the advantages obviously remain considerable. The same advantages explain the very recent phenomenon of private for profit dispute resolution.

Rent-a-Judge Justice

An 1872 California statute states that individuals in a dispute have the right to have a full court hearing before any referee they might choose [18]. In 1980 there was a 70,000 case public court backlog in California with a median pre-trial delay of 50 and one-half months. Thus, it is not too surprising that two lawyers who wanted a complex business case settled quickly "rediscovered" the statute; they found a retired judge with expertise in the area of the dispute, paid him at attorney's fee rates and saved their clients a tremendous amount of time and expense.

No count of the number of "rent-a-judge" cases tried since 1980 exists, but the civil court coordinator of the Los Angeles County Superior Court estimated that several hundred disputes

had been so settled through the first five years of operation in their county. Most of the private cases involve complex business disputes that litigants "feel the public courts cannot quickly and adequately" try [18, 51]. Private judging is now a growth industry across the country. Indeed, several private for profit firms have entered the justice market in several states during the past few years [12]. The California statute and others like it in some other states treat all private judges' decisions like arbitrated judgments, but there are a couple of subtle differences between the system developing now and arbitration. First, individuals and firms in several states are now actively seeking disputes to judge in order to earn profits. And second, arbitration clauses in previously existing contracts are not what moves disputes into these private courts.[9]

VII. Modern "Legislation" of Commercial Law: Customs and Contracts

The commercial sector continues to develop an expanding base of customary law. Order clearly arises from contractual agreements, for instance. Thus, contracts negotiated and voluntarily entered into by private individuals provide one form of privately created law. If a contract is a standard one based on long standing tradition, it simply reflects existing customary commercial law; if a contract develops an effective new business practice in the face of a new situation, it is likely to add to customary law. Since commerce operates in a dynamic continually changing environment, new contractual arrangements are always being mediated—new law is being created.

Arbitration also can, and often does, create law by setting precedents which become part of customary law. This contradicts Landes and Posner (among many others) who contended that commercial arbitration does not set precedents, but simply applies laws established by government courts and legislation [13, 257–258]. That they are wrong can be superficially demonstrated by the fact that when individuals wish to agree to something which may not stand up in government courts, they frequently write an arbitration clause into the contract [24, 104]. Private commercial arbitrators will consider the contractual agreement to be valid. Furthermore, recall the competition between public and private courts. Public courts managed to take a dominant position in commercial dispute resolution by first enforcing laws the merchant community developed in a fashion consistent with merchant needs (e.g., quickly).[10] When the common law and/or public court procedures departed too far from what merchants desired and began to raise costs to merchants such as the delay arising with court congestion, however, commercial arbitration surfaced again. Commercial arbitration should enforce virtually the same laws recognized by the public sector under these circumstances, but causation actually flows in the opposite direction to that suggested by Landes and Posner. When government courts do not enforce merchants' law, the public court bureaucracy loses even more of its commercial business as more businessmen use their own courts (as indeed they are). Thus, commercial law precedents are largely being set by the private sector in the process of developing customary law, even if some laws become articulated in the context of litigation before a common law court.

If a dispute arises because a contract did not anticipate a change in business environment, the arbitrator will have to determine what business practice should be under the new conditions

9. Landes and Posner [13, 237] implied that private adjudication is not a viable option without previously existing arbitration clauses in contracts. The emerging judicial market casts doubt on this claim.

10. See note 8 in this regard.

based on what custom and practice has been under related but not identical circumstances. When this occurs, as it frequently does, then without any formalized state doctrine set out by legislation or public judicial precedent, the private adjudicative determination will enter into the litigants' future relations as well as the future relations of other possible litigants before the same type of tribunal. A statement by the private tribunal of the reasons for its decision is not even necessary, because a reason will be perceived and people will govern their conduct accordingly [7, 90]. In other words, a new law has been created that begins to "govern" the behavior of parties entering into similar circumstances in the future. Such a law is likely to be recognized very quickly when the arbitration involved was internal to a trade association. It may take longer to spread through the relevant commercial population if the group is more diverse, but if it is an effective remedy to a now frequent potential conflict it can catch on quite quickly anyway [3], becoming part of customary law.

It is often difficult to see the important role that customary law plays in determining commercial order since so much of custom has been codified or coopted by common law courts, and claimed as state law. One instance of order through customary law remains relatively free of state-interference, however. International trade is still largely ruled by customary commercial law as it has evolved from the medieval Law Merchant.

The International Law Merchant

International commercial law is a universal law [23]. The merchants themselves are the only potential source of legal uniformity, of course. Their agreements have to produce it since agreements between governments are not likely to. Many international trade associations have their own conflict resolution procedures. Other traders rely on the International Chamber of Commerce (ICC) which has established a substantial arbitration institution. ICC arbitrators are experts in international commerce; their procedures are speedy and flexible reflections of commercial interest. These private commercial adjudication processes are modern versions of the medieval fair and market courts. The decisions and agreements that arise are backed by the reciprocal arrangements of the international commercial community.

The International Law Merchant has certainly grown and changed substantially since its medieval beginnings.[11] However, the primary principles underlying customary business law are not likely to change [23, 7]. The basic rules of private property and freedom of contract developed centuries ago [3]. As international commercial law continues to develop, the need for extensions of these basic principles to cover unanticipated circumstances always arises, however, and customary law adapts, building on the existing base of substantive principles. The point is that customary law

11. This is the characteristic of common law that Landes and Posner [13], Leoni [15], Rubin [19], Hayek [10] and others have found desirable. They attribute this characteristic to the fact that common law is judge made law. But common law, assuming away legislative interference by non-judges (e.g., Kings, legislators, bureaucratic administrators) and outright authoritarian legislation discretionarily imposed by judges themselves, would grow gradually. It would, in other words, grow and develop in a fashion similar to the way the customary Law Merchant grows and develops (see footnote 12 for an indication of how government law really grows). In particular, it would grow as a consequence of the mutual consent of parties enterings into reciprocal arrangements. Two businessmen may agree to call upon an arbitrator or mediator to lead them to a conflict solution. The solution only affects those parties in the dispute, but if it turns out to be an effective one and the same potential conflict arises again, then it will be voluntarily adopted by others. In effect, the private arbitrator/mediator has no authority over anyone beyond what individuals voluntarily give them by requesting a particular decision and adopting it after it is made. Their decision carries no weight for others unless it is a good one that others find useful in facilitating interaction.

grows, it does not change in the sense that an old law is suddenly overturned and replaced by a new law. That growth tends to be gradual but fairly continuous, through spontaneous collaboration.[12]

Beyond its ability to grow and adapt, the international Law Merchant has proven to be a very effective source of order [23, 3]. The fact is that the international Law Merchant, free from the dominant influences of governments and localized politics, has developed and grown much more easily and effectively than has intranational commercial law constrained by the government imposed laws of most (probably all) nation-states.

VIII. Conclusions

Most economists have assumed that for markets to work government must define and enforce "the rules of the game"—private property rights, contract law, etc. An exploration of the rise and continued domination of the Law Merchant casts considerable doubt on this widely held premise.[13] The merchant community actually developed its own law in order to avoid the inefficiencies and political nature of royal law and government (e.g., common law) courts. Indeed, as Hayek explained "the growth of the purpose-independent rules of conduct which can produce a spontaneous order will . . . often have taken place in conflict with the aims of the rulers who tended to turn their domain into an organization proper. It is in the *ius gentuim*, the law merchant, and the practices of the ports and fairs that we must chiefly seek the steps in the evolution of law which ultimately made an open society possible" [10, 82].

Adam Smith described the spontaneous order evolving out of market processes as developing as though guided by an "invisible hand." The market process could not develop and evolve without a coterminously evolving, clearly defined and enforceable set of rules of property and contract, of course. Thus, the invisible hand guiding the development of the market's spontaneous order had to be supported by another invisible hand which guided the evolution of commercial law. Neither of these evolutionary processes could have been achieved by intentional design. Development of trade required simultaneous development of law, but commercial law could not develop without changing requirements in trade. Thus, evolving trade practices provided the primary rules of evolving commercial law. Both were "produced" by the same people—the merchant community. They had to be, and they continue to be cooperating evolutionary processes—two invisible hands, fingers intertwined to produce commercial order.

Customary law continues to "govern" most commercial interaction even today. It is difficult to visualize this, in part because customary law "owes its force to the fact that it has found direct expression in the conduct of men toward one another" [7, 212]. Customary law's authority is based on voluntary recognition of rules of obligation because of reciprocal gains from recognition. Thus, it is much less likely to be violated than enacted law, imposed by a state and lacking reciprocity. Its role and impact are simply less likely to be noticed as a consequence. Nonetheless, customary commercial law flourishes and promotes order in most of our modern merchant society, much as it did in the medieval period. Differences arise only because various governments have

12. This is very different than the way legislated law grows, and despite Leoni [15], Landes and Posner [13] and others (see note 11), it can be very different than the way common law grows. Legislation imposed by a coercive authority (king, legislature, bureaucracy) can make major alterations in law without the consent of all parties affected. It becomes enforceable law for everyone in the society whether it is a useful law or not. Judge made common law precedents take on the same authority as statute law, of course.

13. When this is added to stateless primitive law's emphasis on private property [3] this assumption becomes even more tenuous.

been partially successful at subjugating the Law Merchant, not because government has had to provide and enforce certain rules of the game.

Actually, the private sector has to be the primary source of law necessary for the support of a market system. Politically dictated rules are not designed to support the market process; in fact government made law is likely to do precisely the opposite [15, 90]. Indeed, it appears that the increasing governmentalization of law making has been associated with increasing transfers of property rights from private individuals to government, or perhaps more accurately in representative democracies, to interest groups.[14] In other words, public production of law undermines the private property and contract arrangements which support a free market system. Government statutes may appear to be creating and enforcing private rights and contract law in many countries, but that simply reflects the demands of powerful interest groups (the business community naturally prefers to shift the cost of enforcing their laws onto others), and/or the competitive/coercive efforts of public courts to attract/takeover business disputes.

14. This is a natural extension of the developing interest group theory of government, and/or the rent-seeking paradigm [2; 3; 21; 22].

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