# It Takes Two Invisible Hands to Make a Market: *Lex Mercatoria* (Law Merchant) Always Emerges to Facilitate Emerging Market Activity

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**Abstract:** The privately produced, adjudicated and enforced body of customary law that governed commerce in medieval Europe is called the "Law Merchant". Allegedly, this system was displaced by the end 1600, but since the 1950s, the term also has been applied to international commercial law. "Law Merchant" has considerable more relevance, however: a Law Merchant evolves whenever commerce emerges. Practices that facilitated emergence of commerce in medieval Europe were replayed in colonial America, and they are being replayed in Eastern Europe, Eastern Asia, Latin America, and cyberspace. Law Merchant arrangements also support "underground" economic activity when states constrain above-ground market development.

**Keywords:** Law Merchant, customary law, credibility, contract, arbitration, polycentric law

*Lex Mercatoria*, or the "Law Merchant" usually refers to the privately produced, privately adjudicated and privately enforced body of customary law that governed virtually all commercial transactions in Europe and the Middle East by the end of the eleventh century. Many writers suggest that this system of law was largely displaced in Europe by the end of the seventeenth century, but beginning in the mid-1950s, *Lex Mercatoria* also began to be applied to certain aspects of modern international commercial law. The argument presented below is that Law-Merchant processes and institutions have considerable more relevance both historically and today. Elements of a law merchant evolve any time a commercial system emerges, so many of the practices that facilitated the emergence of commerce after the "dark ages" in Europe were replayed in colonial America, and they are being replayed as Eastern Europe emerges from the dark ages of communist rule, as well as in the emerging markets in cyberspace. Law Merchant arrangements also support "informal" or "underground" economic activity in the face of state-imposed constraints on market development, such as the protectionism of mercantile Europe, and the dysfunctional state legal systems in places like Vietnam and Peru.[2] In order to support these contentions, Section I provides an overview of the medieval Law Merchant. Section II suggests that the same processes are important for the emergence and evolution of intra-national commercial activity and for cyber markets. Concluding remarks appear in Section III.

## I. *Lex Mercatoria*

Rapid expansion in agricultural productivity during the eleventh and twelfth centuries meant that less labor was needed to produce sufficient food and clothing for Europe's population, so individuals began specializing in crafts, and population began to move into towns, many of which rapidly became cities. Trade is required with specialization, and the class of professional merchants expanded to facilitate such trade.[3] Merchants spoke different languages and had different cultural backgrounds, however, while geographic distances often prevented direct communication as numerous middlemen were frequently required to move products from their producers to consumers. All of this produced high transactions costs, as concern over the credibility of promises limited the potential scope of trade. Extensive international trade required establishing and expanding the potential for credible commitments by creating the potential for recourse to support growing merchant networks. Internationally recognized and enforceable commercial law was required, and as Berman (1983: 333) emphasizes, it was during this period "that the basic concepts and institutions of ... *lex mercatoria* ... were formed, and, even more important, it was then that [this] ... law ... first came to be viewed as an integrated, developing system, a <u>body</u> of law."[4] For instance, Greif

(2006: 58-77) examines eleventh-century documents produced by Maghribi traders,[5] and quoting from various Maghribi documents (2006: 70), he explains that,

> Given … communication and transportation technology in the eleventh century, it is not surprising that the Maghribi traders … employed a set of cultural rules of behavior – merchants' law ….
>
> The importance of the merchants' law in determining expectations about and attitudes toward an agent's behavior is reflected in the letter written by Maymum ben Khalpha to Naharay ben Nissim. In discussing the conflict between Naharay and his agent, Maymum justifies the agent's actions by arguing that the agent "did something which is imposed by the trade and the communication [system; what you asked him to do] contradicts the merchants' law." …. In another letter a "very angry" merchant accused his business associate of taking "actions [that] are not those of a merchant."

Greif (2006: 71) also notes that numerous early Islamic documents indicate that Islamic law was not applied to merchants because of the "custom of the merchants". Clearly, "merchants' law" was not unique to the Maghribi. Similarly, Face (1958: 438) examines twelfth- and thirteenth century documents from Genoa and finds that many substantive merchant rules (e.g., how to establish and interpret credit instruments, partnership arrangements, contracts with agents and with transportation specialists) were

> fully developed by the year 1180. [But] One must look far behind that date to discover the origin of these practices. The pattern of the fair, with all its concomitant devices of business and financial organization, was worked out at some time too early for any written records to have survived…. A system so complex, so carefully worked out, could not have sprung up within a few years.

As indicated below, this lack of records reflects the fact that the Law Merchant evolved just as markets evolve, from the bottom up through individual interaction.[6]

**Law Merchant Rules.**

Hayek (1973: 96-97) explains that many issues of "law" are not "whether the parties have abused anybody's will, but whether their actions have conformed to expectations which other parties had reasonably formed because they corresponded to the practices on which the everyday conduct of the members of the group was based. The significance of customs here is that they give rise to expectations that guide people's actions, and what will be regarded as binding will therefore be those practices that everybody counts on being observed and which thereby condition the success of most activities." Similarly, Fuller (1981: 213) stresses that, "We sometimes speak of customary law as offering an unwritten code of conduct. The word code is appropriate here because what is involved is not simply a negation, … but of this negation, the meaning it confers on foreseeable and approved actions, which then furnish a point of orientation for ongoing interactive responses." The Law Merchant is customary law.

Customary law evolves spontaneously from the bottom up (Pospisil 1971; Benson 1989, 1990, 2009).[7] For instance, if conditions change and a set of individuals decide that, for their purposes, a new kind of behavior will support more beneficial interactions than the current behavioral rule, they can voluntarily agree to follow (contract to adopt) the new behavior within their own interactions. Thus, an existing rule is replaced, but only for the contracting parties. This change occurs without prior consent of, or simultaneous recognition by, anyone else. Individuals who interact with these parties learn about their contractual innovation, however, and/or members of the community observe its results. If they believe that the results are more desirable than outcomes under older practices, the behavior can be rapidly emulated. As Fuller (1981: 224-225) explains, "If we permit ourselves to think of contract law as the 'law' that parties themselves bring into existence by their agreement, the transition from customary law to contract law becomes a very easy one indeed." In fact, contract and custom are intertwined:

> if problems arise which are left without verbal solution in the parties' contract these will commonly be resolved by asking what "standard practice" is with respect to the issues... In such a case it is difficult to know whether to say that … the parties became subject to a governing body of customary law or to say that they have by tacit agreement incorporated standard practice into the terms of the contract.
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> ... [In fact,] … the parties may have conducted themselves toward one another in such a way that one can say that a tacit exchange of promises has taken place. Here the analogy between contract and customary law approaches identity (Fuller 1981: 176).

Contracting also is the most important method for initiating change in customary law (Fuller 1981: 157).

As conditions change, a gap in existing custom can be revealed because a dispute arises. Negotiation is the primary means of dispute resolution, reinforcing the contention that contracting is a primary mechanism for initiating change in customary law. If direct negotiation fails, however, the parties to a dispute often turn to arbitration or mediation. Law Merchant procedures are detailed below, but for now, note that a new behavioral rule might be suggested by resulting third-party dispute resolution (Fuller 1981: 110-111). Unlike common law precedent, however, the resolution only applies to the parties in the dispute. If it suggests behavior that effectively facilitates desirable interactions, the implied rule can be adopted and spread through the community. Under the Law Merchant, where contract is widely employed, however, arbitrators are more likely to apply general default rules based on equity considerations.

A key distinguishing characteristic of a customary rule is that it is initiated by and adopted through individual decisions to behave in particular ways under particular circumstances. Individuals adopt observed behavioral only if they choose to.[8] When numerous individuals who interact with one another observe each others' behavioral patterns, emulating those that appear desirable, such behavior and obligations spread. In other words, customary rules evolve spontaneously from the bottom up, and they are voluntarily accepted rather than being imposed. Rules evolve through a process similar to natural selection, as desirable rules survive and relatively poor rules are displaced. After all, no one would voluntarily recognize such a legal system that was not expected to treat him fairly.

Considerable change in the medieval Law Merchant occurred in a relatively short time. In fact, Berman (1983: 350) concludes that, "a great many if not most of the structural elements of the modern system of commercial law were formed in this period." By the twelfth century, commercial law in Europe provided alien merchants with substantial protection "against the vagaries of local laws and customs," and by the early thirteenth century the Law Merchant clearly was an integrated system of principles, concepts, rules and procedures. Berman (1983: 341) notes that over the period from 1000 to 1200, and especially 1050 to 1150, the rights and obligations of merchants in their dealings with each other "became substantially more objective and less arbitrary, more precise and less loose."

The foundational principles of the Law Merchant apparently were universally recognized throughout commercial Europe by the end of the twelfth century:

> within the appointed area of the Law Merchant no one wants to depart from the norm of freedom of contract… With that concurrence as to ends, huge sources of potential disagreement just disappear from view… There might not be perfect agreement among the practitioners ... [about] what ideal customs are. But this fundamental agreement on ends was universal … Any differences in local culture could not push anyone away from basic principles (Epstein 2004: 8-9).

Kadens (2004) depicts the customs of medieval merchants as layered, and notes that the "top layer" was "similar across Europe" (Kadens 2004: 56). While fundamental "top-layer" rules were universal [see Benson (2009) for an elaboration of these rules], an evolving commercial system required evolving rules to meet new circumstance. In addition, localized trade in specific commodities might require rules that did not arise in other localities where different commodities were traded. Therefore, variation in specific "lower-layer" rules and practices always existed across medieval merchant communities (Benson 1999, Kadens 2004). As Hayek (1973: 47) explains, a spontaneously evolving order "need not have such sharp boundaries as [a designed] organization will usually posses. There will often be a nucleus, or several nuclei, of more closely related individuals occupying a central position in a more loosely connected but more extensive order." Nonetheless,

> The fact that customs were local or trade-specific did not mean that they had no effect on commerce in general. The Italian wool buyer in England followed English custom; the Fleming who purchases a bill of exchange in Paris followed the local *usance*. One of the prevailing tropes in works by merchants on trade practices is the discussion of the rules one must follow in different locales. Knowing those rules and working within them was part of how a trader abided by the law merchant (Kadens 2004: 62-63).

Indeed, since some rules varied from place to place, one of the important tenets of the Law Merchant was that local rules were to be followed given that they were consistent with the fundamental universal rules (Benson 2009). As a result, itinerant consul often travelled with groups of traders of a particular nationality, specializing in determining the rules and practices in the markets and fairs they visited, and watching over the community's interests (Bewes 1923: 85). Merchants also retained agents who spent much more time at fairs or foreign markets than the merchants themselves (Face 1958; Greif 2006), acting on behalf of their merchant employers and gaining an understanding of local practice and usage.

Customary rules generally are not recorded. Some obligations may appear as standard contract clause, but contracts typically do not specify widely understood practices and usage. Indeed, "the rules that govern the actions of the elements of such a spontaneous order need not be rules which are 'known' to these elements; it is sufficient that the elements actually behave in a manner which can be described by such rules. The concept of rules … does not imply that such rules exist in articulated ('verbalized') forms, but only that it is possible to discover rules which the actions of the individuals in fact follow" (Hayek 1973:43). Therefore, behavior has to be observed to conceptualize customary rules. When observation is not possible (e.g., when historical systems are studied), the best one can generally do is to read contracts, letters and other documents that might reveal behavior, as Greif (2006) has done, for instance.[9] Let us turn to some of these records to see what they reveal about the medieval Law Merchant.

Face (1958: 428) reports that "Even the most superficial examination of the Genoese documents [notarial entries from 1180 through the thirteenth century] … indicates that as early as 1180 … the yearly cycle of the six fairs of Champagne was fully developed, and that the internal divisions of the order of business at each of these fairs had ***evolved at some time long before***, and continued to regulate and to dominate all business activity" [emphasis added]. The cycle of Fairs in six different Champagne towns, each lasting about 52 days, took place every year. These fairs all were organized as follows: (1) eight days of "entry" when merchants set up their shops, (2) ten days during which only cloth was traded, (3) eleven days during which cordovan (leather) goods were traded, (4) nineteen days for the trading of goods that were sold by weight, such as spices and dye-stuffs, and when accounts began to be settled, and (5) four days during which the "letters of the Fair" [credit instruments; e.g., to deal with unsold goods that might be stored, or individuals who purchased more than their revenues would cover] were drawn (Face 1958: 427 and note 2). Cloth was exchanged for promises to pay later, in the form of promissory notes or perhaps letters of credit from money lenders, because the buyers of cloth did not sell their spices and other goods until after the cloth exchange ended. These instruments could then be used by cloth sellers to purchase spices and other items later in the fair (many credit instruments were negotiable). Similarly, the *Little Red Book of Bristol* (Basile 1998[c. 1280]: 11), the oldest English account of the Law Merchant that has survived, states that "it is well known to all that merchants sell their goods and merchandize on credit … and also that servants and apprentices of such merchants [sell on credit] the goods and merchandise of their lords to other men in the same way …" (parenthetic in original). Since trading with credit instruments was the norm, credibility clearly must have been well established.

Face (1958: 429) also reports that Genoese "caravan" merchants who traveled to the fairs, bought spices and/or cordovan on credit from Genoese importers. When they returned after Champagne, they made numerous sales of woolen and linen cloth to Genoese "*draperii*," again on credit. Furthermore, Genoese caravan merchants often did not even arrive at the Fair in time to buy cloth. Instead, merchants generally contracted with agents or partners who established themselves at the fairs in Champagne (Face 1958: 433). Therefore, the promises of merchants' agents also had to be very credible. Merchants who did travel to fairs left agents or partners to tend their affairs in Genoa, and many had additional agents representing them in other places in the north (Face 1958: 432). In fact, documents suggest that some merchants simply stayed in Genoa, continually selling northern cloth purchased by agents and making large purchases of spices and other commodities on credit to be sold by agents in Champagne (Face 1959: 245). To carry out such activities, merchant also contracted with professional freighters or "*Vectuarii*". Clearly, freighters' promises to deliver were credible. And importantly, clauses "repeated word for word in four separate contracts, seems a reliable indication that by 1248 a substantial and generally known set of obligations existed to which *vectuarii* were required to adhere by custom … in their professional dealings with merchant" (Face 1959: 240-241). In addition, new clauses were added to these contracts over time.

Face (1958: 430) explains that twelfth- and thirteenth-century merchants employed "A group of advanced and polished techniques of business [that] enabled them to carry out a seemingly impossible task with the utmost regularity and precision. These techniques are hinged on three factors: first, the ingenious use of partnerships, agency, and procuration; second, the integration of these devises with communication and transportation; and third, the extensive use of credit instruments in the trade." These techniques clearly had to be based on contracts, which in turn required credibility. It is in this context that Berman (1983: 350) statement that "a great many if not most of the structural elements of the modern system of commercial law were formed" prior to and during the period when the documents examined by Face should be understood. Indeed, Berman's (1983: 341) conclusion that the rights and obligations of merchants in their dealings with each other "became substantially more objective and less arbitrary, more precise and less loose" by 1200, and probably by 1150, appears to be quite consistent with evidence provided by Face (1958, 1959), and by Grief (2006). Essentially, a widely accepted (universal) set of fundamental rules substantially lowered the cost of interpreting localized rules, because all local practices and usage were expected to be consistent with the fundamental rules. Many local practices and usage also were very similar, if not identical, particularly after inter-community trade had been going on for awhile, as profit-seeking merchants naturally looked for practices that minimized their transactions costs.

**Incentives to Recognize Merchant Law.**

The Law Merchant was voluntarily recognized. The reciprocity necessary for voluntary recognition arose, in part [and probably initially], by developing bilateral repeated exchanges between individuals with similar ethnic, religious, or geographic backgrounds. However, by the eleventh century, "traders were associated with many traders residing in different trade centers. It was [or, at some point, became] customary for merchants to supply their business associates with trade-related information, which was crucial to business success" (Greif 2006: 64). This information flow has important implications. First, incentives to behave as expected by other merchants become stronger, so behavioral rules and resulting expectations tended to spread through such networks. Second, reputation for honesty becomes valuable. In discussing relationships between Maghribi merchants and agents, for instance, Greif (2006: 62-65) notes that there is a serious credibility problem because monitoring an agent conducting business with a merchant's capital in a distant location is costly, creating an opportunity for agent embezzlement. The flow of information allowed merchants to more effectively monitor agents, however, and it also provided a mechanism for agents to signal honesty: "eleventh-century Maghribi agents generally conducted important business in the presence of other coalition members. In their reports they included the names of witnesses the merchant knew, thus enabling the merchant to verify the agent report" (Greif 2006: 65). Merchants hired the same agents repeatedly as long as information indicated agent honesty. Indeed, honest agents earned a premium. Furthermore, "All coalition merchants, however, are expected never to employ an agent who cheated while operating on behalf of a coalition member" (Greif 2006: 66). Greif (2006: 69) stresses that this ostracism process was an "uncoordinated response of the merchants located in different trade centers." It arose spontaneously as a result of the common practice of sharing information, individual incentives to avoid dealing with dishonest merchants or agents, and observation of this "avoidance" behavior by other merchants. Despite the lack of a coordinated response, Greif (2006: 66-69) cites several Maghribi documents illustrating this sanction's impacts. For instance, letters written in 1055 discuss an agent in Jerusalem accused of embezzling from a Maghribi trader. As word spread, merchants "as far away as Sicily" canceled contracts with the agent.

Agents and merchants also were willing to sacrifice immediate gains to maintain their reputations. One revealing incident involved a contract for flax purchase. The parties agreed price was 13 dinar per load, but before the flax arrived, the price fell to eight dinar. The buyers initially refused to pay 13 dinar, but ultimately did so. Greif (2006: 68) quotes a seller's letter: "if not [for their fear of losing their] honor … we wouldn't have received a thing." Similarly, when a merchant made a large profit relative to a partner, he shared the profit with the partner even though the partnership was not being renewed: "the merchant acted honorably solely to maintain his reputation with other coalition members" (Greif 2006: 69). Greif (2006: 63) reports that "Despite the many opportunities for agents to cheat only a handful of documents contain allegations of misconduct."

While the Maghribi traders quickly boycotted dishonest merchants and agents, partial or conditional ostracism also is a possible sanction. Merchants might continue trading with someone accused of misbehavior, but only if certain conditions are met that reduce the expect risk, perhaps by demanding relatively high returns [e.g., requiring higher prices if selling, or lower prices if buying] or requiring that bonds be posted. These conditions punish the offender by raising his costs of doing business.

As communications about reputations become more effective much larger inter-community trading networks develop. When members of different groups trade, however, ostracism threats become weaker. As a result, the reputation of trading communities also becomes valuable, creating incentives to develop surety arrangements to protect group reputations and increase the credibility of member's promises.[10] As Malynes (1622: 93) explains,

> Faith or trust is to be kept between merchants, and that also must be done without quillets or titles of the law to avoid interruption of traffic, where in his Suretiship is to be considered according to the promise; for if it be conditional if such a man do not

> pay, the other to pay the same within a time, or to save him harmless: it is first to be demanded of the Principal, and if he do not pay, the Surety is to pay it without any course of law, unless he be ordered by the Court of Merchants to perform the same...

These developments do not mean that opportunism never occurred, of course. No legal system is perfect.

**Dispute Resolution.**

"As any practicing commercial lawyer knows, there are many ways of enforcing fair practices, and punishing unfair practices, outside the [government's] courtroom. These patterns of informal enforcement are 'law' to those who operate in that context, and have been called 'law' for centuries" (Coquillette 2004: 298). For instance, arbitrators, generally chosen from the merchant community, were an important option when a disagreement occurred (Malynes 1622 [1686]: 447-454). Each group of merchants at a fair chose a consul to perform various administrative duties, for instance, but these individuals also arbitrated disputes between group members (Bewes 1923: 14; Kaden 2004: 59).[11] Merchants also inserted arbitration clauses in contracts. Face (1959: 243) discusses two fairly complex contracts from 1191 involving an individual renting horses to caravan merchants, for example, specifying that if a horse was injured the degree of injury was to be determined by a board of arbitrators. Arbitration also was chosen after disputes arose. Consider the "Memorandum of Arbitration Concerning a Freight Charge" from a 1229 dispute in Marseilles (quoted in Blancard 1884 Vol. 1: 29):

> Upon the complaint or petition which existed between Martin Castagne … and Stephen de Manduel… on behalf of himself and his son Bernard, about the freight charge of thirty-one bundles of skins, which belonged to Paul Sicard, concerning which skins the said Martin and his associates said that they had retained them until the charge they demanded was paid; but on the other hand the said Stephen said that the charge should be paid by Paul Sicard, or by someone on his behalf, and that Bernard de Manduel, son of Stephen, had bought or otherwise acquired the said thirty-one bundles free from freight charges … and free from all other burdens, for which charge Stephen placed twenty-four pounds in the keeping of Bernard Peter … This money ought to be in the possession of Bernard Peter, for the charge on the thirty-one bundles if it appears that the said charge was not paid. For this charge or for the complaint about the charge Stephen and Martin have agreed before Bernard Peter and John of St. Maximin, judges chosen freely by both contestants … both promised to submit to the judgment or decision of the judges, however the judges might wish to settle the matter

> according to equity, requiring the truth, and, according to what appeared from the hearing of the complaint, to disregard the due order of legal process and the solemnity of the law. The said judges, having required the truth, and having heard the testimony … according to the wish of both parties, and having … the said judges agreed and gave their decision as below … according to what seemed just and honest to them. Wherefore the said Bernard Peter and John of St. Maximin, the said judges … absolved Stephen for himself and his son from paying the freight, ordering besides that the twenty-four pounds, which Bernard Peter had in his possession, should be restored to Stephen by Bernard, without objection by any one...
>
> This decision was made by the said judges in the shop of William Aicard...

This is an unusual document since medieval arbitration decisions were rarely recorded in any detail. In fact, as Malynes (1622 [1686]: 450) notes, medieval "Arbitrators have a determinate power to make an end of controversies in general terms, without declaration of particulars." This was the case because of the merchants need for quick solutions to their disputes, as discussed below, and the fact that arbitrators chosen to resolve disputes had "skill and knowledge of the Customs of Merchants, which always does intend expedition" (Malynes 1622 [1686]: 450).[12]

Participatory merchant courts were also established at fairs, particularly during the early years of the medieval Law Merchant. While the origins of these fairs courts, called *Piepoudre* or Pie Powder courts, cannot be determined, surviving records from the tenth through the twelfth century do not suggest that kings or local lords created these courts, but judges often were the consuls chosen by each merchant group attending a fair (Bewes 1923: 14). *The Little Red Book of Bristol*, c. 1280 (Basile 1998) stresses that one important difference between the Law Merchant and royal (common) law was that Law Merchant disputes were resolved quickly because most merchants had to complete transactions at one fair to move to the next. This is one reason for using Pie Powder judges from among merchants attending the fair or market (e.g., group captains/consuls). Another is that clerics, lawyers, local lords, and royal judges might have little knowledge of many commercial issues, so the risk of judicial error was lower with merchant judges, particularly when highly technical issues were involved. In addition, non-merchant judges might not accept evidence that merchant judges respected, as Zoache (1663 [1686]: 128) observes,

> At the Common Law no mans Writing can be pleaded against him, as his Act, and Deed, unless the same is sealed, and delivered: But in Suites between Merchants, Bills of Lading, and Bills of Exchange, being but Tickets, without Seals, Letters of advice, and

> Credence, Policies of assurance, Assignments of Debts, all which are of no force at the Common Law, are of good credit and force by the Law-Merchant. To which may be added, what Malines observes, that the bearer of such Bills, by the course amongst Merchants, shall be admitted to demand, and recover the Contracts, without Letters of Attorney, which is not admitted in the Common Law.

Pie Powder courts did not leave significant records, but this is not surprising since their purpose was to provide quick and equitable dispute resolution. Merchant judges had no precedent setting power, so as with arbitrators, these judges had "a determinate power to make an end of controversies in general terms, without declaration of particulars" (Malynes 1622 [1686]: 450).

Local authorities who successfully maintained important annual fairs or markets over time allowed Pie Powder courts to function without interference. The Champagne fair courts operated for close to a century (and probably longer), for instance, before the Count appointed wardens to deal with administrative and judicial issues. Similarly, Piergiovanni (1995, 1998), drawing on information from fifteenth-century *consiia,* concludes that merchant courts in Italy operated independently from other tribunals. This apparently did not change significantly until the sixteenth century.

Kadens (2004: 64) notes that "merchants, at least in northern Europe, also used a second sort of court – that of the town, the prince, or the Church, in other words, noncommercial court." Some of the other legal systems that were evolving during the medieval period [see Berman (1983)] had relevant rules in common with the Law Merchant or their judges offered to apply Law Merchant rules, so if the court was willing to try the case quickly, and the court had a reputation for fair unbiased decisions, merchants certainly could choose to use it. Ecclesiastical courts were often available, for instance, because many of the major fairs were held at important priories and abbeys. Furthermore, as Bewes (1923: 9) notes, "the Canon law … was the prevailing authority and would tend ,,, to favour simple good faith unhampered by formalities, and thus would extend its influence to the law merchant which, until damaged by legislation, rested on mutual confidence and good faith to an extent unknown in civil life. In this connection it should be remembered that in the Middle Ages the Church was a very considerable trader." Indeed, it was in the interests of church's leaders to maintain good relationships with merchants by offering them quick and equitable dispute resolution.

As suggested above by the appointment of wardens for the Champagne fairs, Pie Powder courts also were taken over by local authorities such as "a mayor of a corporate town … [or] a lord" (Holdsworth 1903: 331). When Pie Powder courts were replaced by a manor or urban court, merchants often dominated dispute resolution, however, as the *Little Red Book of Bristol* (Basile 1998[c. 1280]: 20) explains,

> In every market court, every judgment ought to be rendered by Merchants of the same court and not by the mayor or by the seneschal of the market.
>
> And if such a mayor and seneschal take it upon themselves in any way to render judgments, although judgments do not belong to them in a court of this court, and [if] they execute the judgments or have them executed in any way whereby anyone feels aggrieved by such judgment and its execution, whether the judgment was just or unjust itself …, the aggrieved person should have his recovery both against the mayor, seneschal, or other reeve of the same market who acted thus and against those who execute such a judgment on their order, by a writ of trespass of the lord king, as of a matter done of their own wrong and against law and custom and against mercantile law.

A local lord might resolve merchant disputes quickly using merchant juries, or at least, advice from merchants. He might also enforce court rulings. Merchants were often more than willing to have authorities enforce their law, thereby reducing costs that they might bear personally (Benson 1989).[13] Such courts should not always be characterized as Law Merchant courts, however (Benson 2009). In fact, as commerce developed and merchant communities gained wealth, local authorities and Kings increasingly attempted to assert authority over various aspects of commerce, including merchant courts, in order to increase their power to extract revenues or other benefits.[14]

The success of authoritarian efforts to capture benefits by controlling commerce, including merchant law, depended on several factors, including the degree of competition between jurisdictions (the availability of fairs or markets in other jurisdictions which were more receptive to the Law Merchant), and the mobility of merchants and their wealth. As Jones (1987: 89-90) explains, "the ability of the market to free itself from the worst interferences by the authorities" was a distinctive characteristic of European trade. Arbitration could be used, for instance. Recall that ancestors of the Maghribi traders moved from Bagdad to Tunisia in the tenth century, for instance, because of the political situation in Bagdad (Greif 2006: 61). Similarly, German merchants from the Hanseatic League moved out of Bruge, the Flanders trading hub, in 1288 because Bruge's appointed weighers fraudulently falsified weighings (Kadens 2004: 51). Bruges' government promised to prevent the fraud in order to get the German merchants to return.

As increasing numbers of political jurisdictions imposed themselves on commerce, opportunities for merchants to escape by fleeing a geographic jurisdiction declined. Even so, as Hayek (1973: 51) explains, "it is impossible, not only to replace the spontaneous order by organization and at the same time to utilize as much of the dispersed knowledge of all of its members as possible, but also to improve or correct this order by interfering in it by direct commands." "Opposition norms" inevitably evolve, for instance, as the incentives created by formal institutions and sanctions generally are weak relative to the incentives to pursue personal interests (Nee 1998: 88). As European governments attempted to control and tax maritime trade, for instance, the "average merchant and seaman responded with piracy and smuggling, and a substantial part of maritime commerce was carried out in violation of the laws of some nation-state" (Rosenberg and Birdzell 1986: 92-96). Similarly, craft guilds obtained royal grants allowing them to severely limit entry, but "illegal" production flourished outside urban boundaries (Jones 1987: 99). As Jones (1987: 96) notes, "Rigidities impeding the movement and use of goods and factors of production had to be removed for economies to work efficiently. The lure of profit was sufficient in already commercialized economies to bite into the 'cake of custom' or to get around the regulations." Clearly, royal and urban courts would not enforce contracts arising from illegal transactions. Contracts were still relevant, however, no doubt subject to an underground Law Merchant. These processes and rules were not easily observable and some practices and usage probably were stifled in various ways, making the system relatively less effective than systems with freer trade under an unhampered Law Merchant, but the widespread practice of "illegal" [according to local authorities and kings, but not to merchants] trading implies that many "extra-legal" [but legal under customary law] promises had to be credible. Thus, the Law Merchant became less effective and less dynamic (Trackman 1983). Urban and royal courts were able to displace many Pie Powder courts, and statutes, precedents, and treaties began to interfere with and divert evolving business tradition and practice. Nonetheless, merchant custom survived in varying degrees in international trade and illegal trade (and as noted below, intra-national trade in some places, such as colonial North America), even though legal scholars did not use the term *Lex Mercatoria* to describe it.

As international trade expanded after World War II, the private rules and institutions of modern international commercial law began to be referred to as *Lex Mercatoria*. This is certainly appropriate, as today, international commercial law is largely customary law (Berman and Dasser 1990; Benson 1999). The customary rules of most international trade are still backed by the desire to maintain reputations and repeated-dealing arrangements, and therefore, ultimately, by a boycott threat. Furthermore, almost all international trade contracts expressly mandate arbitration rather than adjudication by national courts. International arbitration procedures are speedy and flexible, but it is also chosen because traders generally assume that national courts will not enforce obligations derived solely from commercial practice and usage, while arbitrators "do not hesitate to refer to international commercial custom, including contract practices in international trade, as a basis for their award" (Berman and Dasser 1990: 33). Lew's (1978: 581) detailed analysis reveals that in arbitration, at least in principle, "The answer to every dispute is to be found *prima facie* in the contract itself. What did the parties intend, what did they agree and what did they expect?" When a contract does not reveal the intentions of the parties, arbitrators still do not refer to nationalized law unless the parties specify doing so in the contract. Instead, they apply a "non-national and generally accepted rule or practice" that the parties should have recognized (Lew 1978: 585).

## II. Intra-National and Cyber Law Merchants

While there is growing recognition that in international trade, a Law Merchant governs once again, Law-Merchant governance is much more important for modern commercial activity than many writers recognize. The same is true historically, for legal international trade and illegal inter- or intra-national trade, including the emerging markets in colonial North America and modern cyberspace.

There is no credibility problem when information is free and complete, but such perfect knowledge does not exist anywhere except in some economists' mathematical models. Information is so scarce in the real world that trust and/or recourse often must substitute for knowledge to make promises credible. Trust and recourse are both substitutes for knowledge, but they are not perfect substitutes for each other. Furthermore, there are alternative ways to build trust, and alternative institutional mechanisms for provision of recourse, all of which are imperfect substitutes. While the governments of nation states are often seen as a potential source of recourse, for instance, an evolving Law Merchant is an alternative which is likely to be a superior source of recourse in emerging commercial economies. In order to illustrate this, let us examine some of the tradeoffs between alternative institutional sources of trust and recourse in emerging markets, many of which can be described as low-trust societies.

**Building Trust**.

Trust, a willingness to make oneself vulnerable to another even in the absence of external constraints, certainly can evolve to support trade. It is widely recognized, for instance, that repeated dealings create an environment conducive to the development of trust, because incentives to employ cooperative strategies (e.g., live up to promises) arise. In emerging economies, repeated-dealing arrangements must be established, however. For instance, McMillan and Woodruff (1999a, 199b), in their study of emerging trade in Vietnam, explain that an entrepreneur tends to be very cautious when considering a potential trading partner. He often visits the plant of the firm he is considering in order to see if the facility appears to be permanent and efficient. He inspects the output of the plant, ask other trusted traders if they have dealt with or know about the potential partner, and so on. The information gathered can never be perfect but if it is positive, a small trade is often arranged. If that one works out, the next one is larger. It is only after several deals that the transactions reach a level that involves a substantial commitment. This can take time, of course, a drawback of relying exclusively on trust relationships.

Traders may be able to gain the trust of others relatively quickly by investing in signals that demonstrate a commitment to fair dealing. For instance, Nelson (1974) explains that the advertising of experience goods serves two primary functions for the rational buyer, and neither of these functions focus on the provision of direct information about the experience quality of commodities that are advertised: first, "advertising relates brand to function" and provides information about the general uses of the product, but second and more important, the volume of advertising is a signal to buyers that shows the extent of committed investment by the seller. According to Nelson, what matters most to a rational buyer is not what advertising says about quality, but simply that it is a recognizable investment in non-salvageable capital: brand name. Advertising may be less important in emerging economies than in developed economies, but other non-salvageable investments (e.g., elaborate store fronts, charitable contributions, community service) can serve the same function. Essentially, such investments are offered as a bond to insure credibility. Buyers must be aware of such commitments, of course, and if so, as Klein and Leffler (1981) explain: "If the consumer estimate of the initial sunk expenditure made by the firm is greater than the consumer estimate of the firm's possible short-run cheating gain" then they will tend to trust the seller.

Markets for trust also can arise (Benson 2005). For instance, an organization (e.g., firm) might develop a reputation for honestly assessing the quality of products or services. Then when someone wants to enter a market and quickly gain trust, he or she can pay for performance inspecting/testing and "certification" by this reputable assessment organization. Consider VeriSign Inc., a leading supplier of encryption technology and public key arrangements, which also provides a digital certificate "verifying that messages sent with a public key are sent by the entity to whom VerisSign distributed that key, an audit service that monitors the entity's use of and continued security of their public key infrastructure (guaranteeing that this entity is the only one with access to the private key for example) and a 'legal' authority to revoke or suspend a certificate in the event that an entity does not pass an audit" (Hadfield 2000: 28). A VeriSign customer gets a "trustmark" posted on his or her website. Clicking on the trustmark moves the user to VeriSign's secure server where the current information and status of the customer's digital certification is displayed. As another example, the American Institute of Chartered Public Accountants and the Canadian Institute of Chartered Accountants (AICOA/CICA) offer a WebTrust program. This combined group audits on-line business practices regarding privacy, security, and the handling of complaints about quality and performance. Firms that obtain a favorable report obtains a WebTrust license and an Enrollment Identification that allows them to apply for certification by a private firm like VeriSign that have agreements to manage a WebTrust seal.[15] Similarly, BBBOnline offers a "Reliability seal" certifying an on-line business as "reliable" and "trustworthy."[16] Certification is non-salvageable investments, of course, since failure to maintain quality results in loss of the investment.

**From Trust to Reputation and Recourse.**

When repeated dealing arrangements and/or non-salvageable investments are valuable, traders obviously have recourse. If a trading partner fails to live up to a promise, commits fraud or behaves opportunistically, the victim can threaten punishment. Sanctions can involve tit-for-tat or exit in repeated dealing arrangements, for instance, but non-salvageable investments create a potential threat that is even stronger: a threat to spread information about non-cooperative behavior. Traders have strong incentives to avoid dealing with an untrustworthy firm, so if the spread of information is sufficiently effective, a spontaneous boycott can be anticipated. Communication mechanisms may be very informal, as groups of merchants meet and "gossip", but they can become more formal (e.g., commercial associations with formal meetings, news letters, etc.). For example, consider Bernstein's (1992) examination of the systematic rejection of state-created law by the diamond industry bourses. She explains that there is a tremendous "unofficial" flow of information as virtually everything about members' behavior tends to "become known through gossip" (Bernstein 1992: 126). More formal information mechanisms also are relevant. For instance, arbitration tribunals for various bourse publish written announcements of the principles used to decide novel cases (Bernstein 1992: 150).

The low cost means of communicating on the internet is having significant impacts on the behavior of cyber merchants. Independent providers are facilitating consumer complaints, for instance. One site, iLevel.com, provides a opportunity for consumers to register complaints against companies, and then iLevel conveys the complaints to the companies. A company is given 30 days to respond to the consumer, and if the consumer has not been satisfied by that time, iLevel posts the complaint and any company response. Other consumers can then check the web site to see if companies have histories of unresolved complaints. Other sites offer means for individuals to spread positive information in an effort to build reputations, but like iLevel, they also provide ways for people to disperse negative information when they have been mistreated.

Negative information can quickly alter behavior if the target of the information wants to maintain survive over the long run, since failure to respond effectively results in spontaneous "punishment." For instance, Cabral and

Hortacsu's (forthcoming: 1-2) empirical analysis of eBay reputation mechanism concludes that sales, prices, and survivability vary significantly across sellers depending on their feedback records, with negative feedback producing significant "punishment": "the growth rate of a seller's transactions drops from about 7% per week to about -7% following the first negative feedback…. We also find that … a 1 % level increase in the fraction of negative feedback is correlated with a 9 % decrease in price…. Moreover, a 1 % level increase in the fraction of negative feedback is correlated with a 1 to 2 % increase in the probability of exit."

**Formalizing Spontaneous Sanctions and Dispute Resolution: Trading Organizations.**

Both commitments and threats can be made more credible, and some uncertainty can be eliminated, if individuals with mutual interests in long-term interactions form "contractual" groups or organizations rather than waiting for trust or reputation institutions to evolve more slowly. Potential contractual arrangements are numerous, including the implicit contracts of family bonds and ethnic networks, indirect equity ties through pyramidal ownership structures, direct equity ties, and interlocking directorates. As Khanna and Rivkin (2006) explain, such business groups are actually "ubiquitous in emerging economies" (as evidence, they cite many studies about groups such as *grupos* in Latin America, business houses in India, *chaebol* in Korea). In addition to creating strong bonds that facilitate interaction and the spread of information, as suggested above, an affiliation with such a group can also be information generating in that it can imply a bond or assurance (a credible signal of reputable behavior) so potential transactors can circumvent the slow process of building reputations in order to create trust. A business organization such as a trade association can also form through contract and substitute for family, ethnic, ownership, or directorate linkages. These organizations can provide a formal mechanism to overcome frictions in communication, insuring that information about any individual's non-cooperative behavior will be transmitted to others in the relevant business community. Trade association membership can include a contractual obligation to boycott anyone who fails to live up to a contractual obligation: specifically, any non-cooperative party will be automatically expelled from the organization. Such automatic ostracism penalties make the reputation threat much more credible. Other sanctions also present themselves in the other kinds of organizations mentioned above. These groups can also lower transactions costs by establishing internal unbiased dispute resolution (e.g., arbitration or mediation).

Consider events in England during the American Civil War. The naval blockade of the South resulted in tremendous court congestion in Liverpool England, the primary port for delivery of American cotton, due to contract claims that would have taken years to untangle. These contracts pertained to the purchase, delivery and sale of cotton arising because many ship owners became unwilling to run the blockade, and some who tried had their cargos seized or vessels sunk. Prices fluctuated unpredictably. Further complications arose due to British neutrality, and contraband-of-war laws. Insurance was either unavailable or it carried new and extremely complex provisions developed in light of the tremendous uncertainty. These provisions required reinterpretation with each new contingency. Because of all these difficulties and uncertainties associated with the blockade, and the resulting public court backlog, the Liverpool Cotton Association agreed to insert arbitration clauses in their contracts. "Arbitration proved so successful in adjusting differences without the expense, inconvenience, and hard feelings of suits that other Liverpool commercial associations took up the device, first the Corn Trade Association and then the General Brokers Association" (Wooldridge 1970: 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) developed arbitration clauses first, followed by stock dealers and produce merchants. Then professional associations of architects, engineers, estate agents and auctioneers took up the practice. "By 1883 a correspondent of the London Times could write that 'whole trades and professions have virtually turned their back on the courts'...Once 'private courts' were tried [again after a few centuries of reliance of public sector courts] their advantages quickly became apparent" (Wooldridge 1970: 99).

A group of traders obviously can institute mediation and/or arbitration alternatives. These services can be produced internally, perhaps by elected members of the organization [as in the diamond bourse (Bernstein 1992)], by mediation and/or arbitration specialists marketing their services, by arbitrators from organizations like the International Chamber of Commerce, the American Arbitration Association, the Hungarian Chamber of Commerce, or any number of other private dispute resolution providers [for discussion of the conditions for and likely relative consequences of arbitration internal to a group versus external options, see Benson (1995, 1999)]. Mediation and arbitration selection mechanisms actually vary widely, but in general, they guarantee that a choice is made without requiring explicit agreement by the two parties while still allowing for prescreening (Benson 1999).

As noted above (Lew 1978: 581), arbitrators first attempt to see what parties intended, agreed to and/or expected by examining their contracts. When the parties' intent cannot be discovered, arbitrators draw upon accepted "practices and usage" (customary rules) in the relevant business community (Lew 1978: 582-585). The same is often true within domestic commerce as trade association mediators or arbitrators apply the associations own rules rather than those of the government of the territory within which the commercial transactions take place (Bernstein 1992, Benson 1995).

Consider the emergence of commerce in North America. Aiken (1974: 160) explored records from the Dutch period in New York (1624 to 1664), for instance, and explained that: "Arbitration in New Netherlands in the 17th century ... was frequent, swift, and relatively simple compared to the English common law." Jones (1956: 209) examined newspapers, merchant letters, and the records of the New York Chamber of Commerce, as well as legal records, and found that arbitration was in constant and widespread use throughout both the Dutch colonial period and the British colonial period (1664 to 1783) in New York. Indeed, there is substantial evidence demonstrating that merchants established arbitration arrangements in each of the American colonies [see Benson (1995) for numerous references]. Furthermore, arbitration was used to settle disputes between businessmen from different colonies; arbitration of disputes between New York and Philadelphia merchants developed in the seventeenth century, for instance, as trade between those communities developed (Aiken 1974; Jones 1956). Note that this reliance on arbitration rather than colonial common law courts occurred during and after the period when many legal scholars suggest that the medieval Law Merchant was being supplanted in England by urban and common law courts. Why did this occur?

The most complete record of an arbitration tribunal during the late eighteenth century is that of the New York Chamber of Commerce. One of the first actions taken by this organization at its first meeting on April 5, 1768, was to make provisions for arbitration, and the Chamber's first arbitration committee was appointed on June 7 of that year (Jones 1956: 207). There is also evidence of "considerable demand" for arbitration services from the Chamber, as committees were appointed regularly except for a period between 1775 and 1779 when the Chamber temporarily suspended meetings because of the war (Jones 1956: 207). After the revolution, the New York Chamber of Commerce continued to provide arbitration to its members (Jones 1956: 211). The fact is that government courts of the period did not apply commercial law in what the merchant community considered to be a just and expeditious fashion: "Not only did courts, according to one New York merchant, dispense 'expensive endless law'; they were slow to develop legal doctrine that facilitated commercial development" (Auerbach 1983: 33). The use of arbitration in the U.S. continued to increase through the nineteenth century. As trade became more specialized and trade associations or other commercial organizations formed, they virtually always created internal arbitration arrangements (Jones 1956: 212). The last part of the century and the early part of the next saw even more rapid growth of arbitration as "the growth of the regulatory state unsettled advocates of commercial autonomy who turned to arbitration as a shield against government intrusion" (Auerbach, 1983: 101).

### What about Turning to the State for Commercial Law and Recourse?

The expanding use of arbitration during a period of increasing availability of public courts and expanding commercial legislation might seem surprising. After all, a stronger sanction might be desirable, and coercive power certainly can provide strong threats. And while customary law can evolve quite rapidly under some circumstances, the state, through legislation, presumably can create beneficial new laws even more rapidly. Despite such potential benefits, there are a number of reasons for avoiding substitution of the state's legal system for alternative (although always imperfect) private (Law Merchant) solutions to the assurance problem, particularly in emerging economies.

Governments of the nations where markets are attempting to emerge face a tremendous knowledge problem which means that they are not capable of doing the things that various commentators suggest that they should do. For instance, legislators, bureaucrats, and judges in places like Russia, Poland, Vietnam, China, and Brazil, are even less likely to understand the important underpinnings of a successful market system well enough to provide effective support than the Western European and North American judges, bureaucrats, and politicians who frequently seem to make decisions that undermine rather than support markets. Indeed, the knowledge problem is ubiquitous, so the decentralized (polycentric) Law Merchant is much more likely to evolve effectively through decisions made by individuals based on their specific knowledge and their expectations about the behavior of the people they deal with directly than a legislature or judge unfamiliar with the intricacies of commerce and commercial practice and usage. In fact, the wide variety of activities and relationships that exist in modern commerce mean that many rules that are effective for one type of transaction or one group may not be effective for another. The diamond traders discussed by Bernstein (1992) may prefer a very different set of rules and institutions than those adopted by the oil traders discussed by Trakman (1983), for instance. The products being traded are very different, of course, suggesting that very different contractual issues are likely to be relevant, but the trading communities are also very different. Diamond bourse members share common ethnic and religious backgrounds, creating an environment conducive to mutual understanding (e.g., of common trade practices and usage) and trust, thus reducing the need for highly technical and specific contracts. Oil traders display much greater ethnic and religious diversity as well as differences in motivations (a number of oil producing states have nationalized production, for instance, so political considerations can have major impacts of decision-making), so the level of common understanding may be low, trust relationships are likely to be weak, and much more specific and complex contracts are probably required. Imposition of a homogeneous set of rules on these two groups would lead to higher transactions costs for at least one group, if not both. Yet, national legal systems tend to produce homogenized (although very complex) law that limits the potential for specialization. Thus, more decentralized lawmaking is desirable in increasingly complex economic systems (Cooter 1994: 216).

There is another problem that arises with state-made law - the concentration of coercive power. While such power might be used to simply extend the scope of basic customary rules, this is unlikely because, in addition to a knowledge problem there is also an interest problem. Coercively imposed rules can internalize externalities and facilitate voluntary interaction, but they also determine the distribution of wealth, and these distributional consequences create incentives to use coercive law to transfer wealth. Indeed, an understanding of state-made law requires recognition of the resulting conflict between incentives for individuals (and organizations) to pursue wealth through both productive and transfer processes (Benson 2005). The use of law to transfer wealth actually reduces wealth for at least five reasons. First, comparative static analysis of a transfer points to a deadweight loss. Second, as Tullock (1967) explains, the resources consumed in the rent-seeking competition for such transfers also have opportunity costs: they could be used to produce new wealth. Third, potential victims of the transfer process have incentives to resist, so rent-avoidance costs also arise through investments in political information and influence. Exit is another option, however, whether by moving to an alternative political jurisdiction, or by moving economic activity and wealth "underground" into what de Soto (1989) calls the informal or extra-legal sector, a very common practice in so-called developing countries. In order to induce compliance with discriminatory transfer rules, the state must rely on enforcement bureaucracies, both to limit exit and to execute the rules. These high enforcement costs are a fourth source of opportunity costs in a wealth transfer process. Finally, faced with the probability of involuntary transfers, productive individuals' property rights to their resources, wealth, and income flow are perceived to be relatively insecure, so their incentives to invest in maintenance of and improvements to their assets, and their incentives to earn income and produce new wealth that might be appropriated, are weak. If transfers are expected to be large, frequent, and arbitrary, production will be low and wealth expansion (economic growth) will be very slow if it occurs at all (and much of what occurs will be in the informal sector(de Soto 1989, 2000). As Pejovich (1995: 17) notes, "The arbitrary state undermines the stability and credibility of institutions, reduces their ability to predict the behavior of interacting individuals, raises the cost of activities that have long-run consequences, and creates conflicts with the prevailing informal rules... [M]ost countries in Eastern Europe [and many other parts of the world] are arbitrary states." When property rights are insecure due to potential arbitrary and/or opportunistic behavior by government (e.g., changes in tax policy to capture the quasi-rents that arise with investments in reputation), incentives to invest in reputation or to count on future dealings are weak and the kinds of private sanctions discussed here are likely to be relatively weak, limiting or eliminating the potential for economic development. Turning to the state is not a solution, however, when it is the source of the problem. McMillan and Woodruff's

(1999a, 199b) interviews of entrepreneurs in Vietnam show that despite their frequent reliance on informal sanctions (tit-for-tat, exit, spreading information about non-cooperative behavior), these entrepreneurs do not want the state to get involved in contract enforcement because they do not trust the state. An emerging economy requires a Law Merchant and a weak state.

## III. Conclusions

If we look to the relatively advanced economies of Western Europe and North America for models of how market economies emerge, we find that markets were well established and governed by customary law long before states got involved in making and enforcing rules of commerce. Furthermore, after state intervention, previously established institutions of trust, recourse (e.g., arbitration, spontaneous ostracism), and customary law survived as a source of competition for the state. Reliance on the state for rules and/or legal sanctions at an early stage of economic development is likely to mean that the future evolution commercial law will be along very different paths than the ones taken in the economies of Western Europe and North America. Withdrawal of the state from any efforts to influence commerce will do more to stimulate the emergence of economic activity than any proactive state efforts to speed up the process: such efforts will inevitably be undermined by the problems of knowledge and interest.

**Notes**

[1] I want to thank Bill Dennis, Gus diZerega and the Fund for the Study of Spontaneous Orders (FSSO) at the Atlas Economic Research Foundation for inviting me to prepare a paper and present it at their conference on "Organization and Emergence: Tensions and Symbiosis". I also thank the conference participants for their helpful comments and friendly criticisms.

[2] These brief remarks should not imply that markets can only emerge when states are "weak". Markets are emerging in places like China too, for instance, where the state clearly is strong enough to impose its rules on markets. In this case, state decision-makers chose to release market forces, however, rather than control them. While I have not examined the underpinnings of credible contracting in this emerging economy, I expect that such an examination would reveal that the growing commercial sector is not relying on state courts to resolve contract disputes. Furthermore, I predict that business communities and organizations are developing processes for spreading information in support of reputation mechanisms and ostracism sanctions. In other words, a Law Merchant is being allowed to emerge, at least to a degree, in order to support the emerging markets.

[3] This is a very incomplete explanation for the expansion of trade. A "little ice age" ended around 1000, for instance, and more land became available of cultivation supporting a larger population. In addition, the Viking threat declined dramatically, making travel safer. The Viking age had militarized much of Europe, however, and military leaders (knights) often turned to subjugation of local communities (protection rackets) when the foreign threat declined. These local "lords" also were in a position to

threatened merchants, although merchants travelled together and hired their own military forces for protection. The strength of Christian beliefs and the resulting "threats" the church could bring to bear (excommunication, the wrath of the Saints) also served as a counter force to the secular powers, mitigating some of the local violence. Monasteries and abbeys were also major producers anxious to engage in trade, so they offered safe havens for fairs. Local powers also wanted traders tovisit their jurisdictions, so the competition to attract fairs (discussed below) constrained aggression against merchants. Then, in 1095 the first of the Crusades attracted many knights and much of their military power, reducing the local threats against producers and merchants. The Crusades also brought new knowledge to Europe (e.g., better medical practices) and a taste for the spices and other "luxuries" available in the Middle East. The point is that a number of important changes occurred in Europe that enhanced both the desire for and ability to trade.

[4] This argument does not apply that the Law Merchant was created out of nothing. There are documents from the first half of the ninth century, for instance, suggesting that merchants were using different legal procedures than those employed in the local communities (Kadens 2004: 43, note 17). Furthermore, while the "great commercial development was new in European hands, it was of centuries standing in the hands of the Eastern nations.... [So] Europe may be indebted to the East for the earliest form of shipping documents, as well as for the law merchant generally" (Bewes 1923: 8-11). However, both this Middle Eastern foundation and the continued evolution of legal institutions in European commercial society, was spontaneous and undesigned.

[5].Because of political insecurity in Bagdad, Jewish merchants moved to Tunisia, part of the Maghrib or Muslim West, in the tenth century. When the Maghrib capital relocated to Cairo near the end of the tenth Century, Jewish traders who followed became known as Maghribi traders. They deposited thousands of contracts, price lists, letters between traders, accounts and other documents in a synagogue in Fustat (old Cairo).

[6] Biologists distinguish between evolving and adaptive processes, and they would describe both markets and the Law Merchant as adaptive rather than evolutionary. In economics, however, the term evolution is commonly used to describe spontaneous processes. The economics definition is used here.

[7] This means that some systems of rule referred to as custom, such as "feudal custom", are not "customary law" as defined here, because these rules have a top-down component. Pospisil (1978) labels top-down rules based on coercion and command as "authoritarian law," a distinction employed here.

[8] The mechanisms that can persuade someone to adopt the relevant behavior are numerous, of course. Children can be persuaded to do so through parental teaching, a charismatic individual might persuade through argumentation or example, and so on. The contention here is that merchants generally choose behavior because they expect it to facilitate their pursuit of trading opportunities.

[9]. Such documents provide an incomplete snapshot. A more complete picture requires theoretical analysis informed by evidence from other customary systems. Benson (1990) compares well-documented customary legal systems to establish basic principles, for instance, before turning to historical systems, including the medieval Law Merchant.

[10] Reciprocal support in the pursuit of justice was generally another intra-group obligation. Thus, as *The Little Red Book of Bristol* explains, a "hue and cry" could be raised if an offender refused to abide by a court decision, resisted efforts to collect debts, removed or reduced the value of disputed assets, or fled (Basile 1998 [c1280]: 25). The purpose of such cooperation was to induce performance of promises or payment of debts.

[11]. Bewes (1923: 14) also notes that in the cities with major markets each group of merchants "appointed consuls [who] had permanent jurisdiction over their nationals."

[12]. Malynes (1622 [1686]: 447) discusses methods of choosing arbitrators to insure unbiased adjudicators with appropriate expertise.

[13] If a lord used his men at arms to pursue offenders, for instance, merchants could avoid the cost of responding to the hue and cry (see Note 5).

[14] Fairs were gradually replaced by permanent market towns, and many of these towns. Kings often granted special privileges to these town's governments, which were dominated by domestic merchant guilds. Privileges include the power to make law, and establish courts. Citing letters reported in *The Little Red Book of Bristol (c. 1280),* Coquillette (1987: note 21) explains that "surviving correspondence forms … show a formula that clearly distinguishes between the law merchant … and the town customs." In fact, many urban governments discriminated against some foreign merchants while simultaneously granting others special access. When this occurred:

> It was only those who belonged to the Guild Merchant who could trade freely within the town. Its conduct was sometimes so oppressive that trade was driven from the town. In fact all the various privileges, jurisdictional and administrative, which the towns possessed could be, and often were used in a manner adverse to the commercial interests of the country. The foreign merchant was hampered at every turn by the privileges of the chartered towns. They were averse to allowing him any privileges except those which they had specifically bargained to give him (Holdsworth 1903: 302).

Agreements between market towns became increasingly common with each granting certain exclusive privileges to merchants from the other. Some agreements became part of geographically-extensive coalitions that discriminated in favor of merchants from the member towns (e.g., the Hanseatic Cities of Northern Europe). The urban (and manorial courts) engaged in such discrimination were not Law Merchant courts when this occurred (Benson 2009).

[15]Clicking on the seal takes the user to the certificate and the accounting report. Periodic audits ensure continuing compliance. Firms with WebTrust seals also must agree to submit consumer complaints that are not resolved through negotiation to a WebTrust-approved third-party dispute resolution process of on-line binding arbitration.

[16]. See BBBOnLine, *About the Reliability Program* at http://www.bbbonline.org/reliability/index.asp. This organizations also has established a three-stage dispute resolution process.

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