“Norms & Law: Putting the Horse Before the Cart”

in *Stateless Commerce: Diamond Dealers, Ethnic Trading networks, and the Persistence of Relational Exchange*

Barak D. Richman

Professor of Law & Business Administration

Duke University

Law & society scholars have long been fascinated with the interplay of formal legal and informal extralegal sanctions.  Unfortunately, there has been a conceptual conflation of very different mechanisms that spur the reliance of extralegal mechanisms.  One mechanism might be described as “the shadow of the law,” made famous by seminal works by Macaulay & Galanter, in which social coercion and custom have force because formal legal rights are credible and reasonably defined. The other mechanism, recently explored by economic historians and legal institutionalists, might be described as “social norms” or “order without law”, borrowing from Robert Ellickson’s famous work.  In this second mechanism, extralegal mechanisms – whether organized shunning, violence, or social disdain – replace legal coercion to bring social order and are an alternative to, not an extension of, formal legal sanctions.

Various forms of arbitration contain elements that resemble both mechanisms, but the penumbra of systems has led to scholarly imprecision.  Specifically, recent scholarship private legal systems—specifically, industry-wide systems of private law and private adjudication—has chiefly been put in the first category and understood as a system to economize on litigation and dispute resolution costs.  Instead, it belongs in the second and should be understood as economizing on enforcement costs.  This is not a small mischaracterization but instead reveals a deep misunderstanding of when and why private ordering arises in the modern economy.

This chapter, which will offer some foundational theory for a book entitled *Stateless Commerce*, will provide a taxonomy for various mechanisms of private ordering. These assorted systems, despite their important differences, have been conflated in large part because there has been a poor understanding of the particular institutional efficiencies and costs of the alternative systems. Specifically, enforcement costs have often been inadequately distinguished from procedural or dispute-resolution costs, and this has produced theories that inaccurately predict when private ordering will thrive and when its costs overwhelm corresponding efficiencies. The implications for institutional theory are significant, as confusion in the literature has led to both an over appreciation of private ordering, an under appreciation for social institutions, and Panglossian attitudes towards both lawlessness and legal development.

Norms & Law: Putting the Horse Before the Cart

Among the most salient features of modern courts is that they’re expensive, slow, and inaccurate. Parties to a contract unsurprisingly anticipate many of these shortcomings and write contracts that can reduce the costs, delays, and mistakes that are often associated with enforcing agreements. Common strategies are to write contracts with detailed substantive provisions, choice-of-law clauses, and—especially—arbitration clauses.

Of course, even detailed contracts are costly and cumbersome to enforce, and parties frequently seek non-legal mechanisms to enforce their agreements. Stuart Macaulay is credited with triggering a renaissance of scholarly inquiry when, in *Non-Contractual Relations in Business: A Preliminary Study*, he reported that businesspeople try to enforce agreements without resorting to legal coercion. Although the observation seems self-evident (perhaps only in retrospect), it marked the start of growing scholarly fascination with the world of extra-legal enforcement: law and society scholars inquired into the social structures that induced contractual compliance, law and economics scholars examined the extra-legal institutions that maintained economic governance, and legal historians investigated how commercial agreements were sustained in pre-modern times the absence of court ordering.

Among the most important strands of scholarship on extra-legal enforcement have been inquiries, most famously by Lisa Bernstein, into comprehensive private arbitration systems, or “private legal systems.” This research primarily consists of case studies of industry groups in which a community of merchants, under the auspices of a trade association, agree to resolve all disputes through private industry arbitration, require commercial dealings to conform to standard contracts and trade practices, and appoint well-respected fellow merchants to serve as arbitrators. Merchants who fail to comply with arbitration decisions are expelled from the trade association and are targeted with economic sanctions, including monetary judgments and the foreclosing of commercial opportunities, and frequently noneconomic social sanctions.

Unfortunately, scholarship of industry-wide arbitration systems has suffered from a lack of conceptual clarity. On one hand, this scholarship emphasizes the substantive rules composed by private legal systems, observing that the tailored rules create efficiencies in resolving disputes. On the other hand, this scholarship also emphasizes the role of extra-legal sanctions in enforcing agreements. In short, scholarship in this area proffers that private legal systems emerge both to economize on dispute resolution and to economize on enforcement costs.

This is not a tenable argument. Enforcement costs and adjudication costs are unlikely to be correlated, and the suggestion that private legal systems arise from both categories of efficiencies only reveals that the economic forces underlying these arrangements have yet to be fully understood. This article articles that private legal systems arise to economize on enforcement costs, with adjudication efficiencies being only incidental. The reason adjudication efficiencies cannot alone justify private legal systems is because private enforcement imposes its own tradeoffs. Because prior scholarship also misunderstands these tradeoffs, it over-emphasizes the role of adjudication efficiencies.

This essay begins with a review of the relevant literature, in particular identifying two distinct categories of private ordering that by-and-large have been conflated. It then offers a theory for how these two categories of phenomena can be understood in regard to each other. Finally, it explains offers preliminary empirical evidence why leading research in private legal systems has largely mischaracterized.  This is not a small error, but instead reveals a deep misunderstanding of when and why private ordering arises in the modern economy.

Two Faces of Private Law

Parties in a dispute use a panoply of mechanisms to avoid the courtroom. One category of mechanisms might be described as operating within “the shadow of the law,” a phrase first coined by Martin Shapiro when he observed a lack of delineation between courts and other systems of adjudication.[[1]](#footnote-1) Although Shapiro used the term to emphasize that the law’s “shadow” was distorted from law itself, the metaphor has come to represent the broad space in which parties understand the possibility of legal coercion. Marc Galanter, criticizing the legal academy’s preoccupation with “legal centrism,”[[2]](#footnote-2) argued that the law’s primary impact on human behavior is through its casting of a shadow. Thus, argued Galanter, the “principle contribution of courts to dispute resolution is providing a background of norms and procedures against which negotiations and regulation in both private and governmental settings take place.”[[3]](#footnote-3)

Under Galanter’s view of the law’s shadow, parties have a reasonably accurate understanding of their legal rights—specifically, the rights that a state-sponsored court will enforce with the state’s coercive powers—and will manage their transactions and disputes accordingly. Stewart Macaulay’s early observations that businesspeople will seek to avoid litigation, particularly if less expensive alternatives are available, is best understood as parties maximizing within the law’s shadow. Robert Mnookin and Lewis Kornhauser both modeled and explored the parameters of the law’s shadow in their seminal analysis of divorce settlements.[[4]](#footnote-4) George Priest’s and Benjamin Klein’s economic analysis of how parties settle disputes also falls within the understanding of how the law’s shadow encourages private ordering within public legal constraints.[[5]](#footnote-5)

The world of arbitration also falls neatly within Galanter’s shadow. Parties enter into agreements with the confidence that those agreements are enforceable by state-sponsored courts. Parties similarly understand the default rules embedded within state-made contract law and procedural law, and they superimpose their own rules and procedures that better meet their needs for their particular agreement. The privately-crafted substantive rules are credible because they are written within the law’s shadow

A second mechanism could be described as “social norms” or “order without law”, borrowing from Robert Ellickson’s famous work.  Although this mechanism has recently attracted enormous attention from legal scholars of all sorts, its logic might simply follow from Machiavelli: “People cannot make themselves secure except by being powerful.”[[6]](#footnote-6) In this second mechanism, extralegal mechanisms – whether organized shunning, violence, or social disdain – replace legal coercion to bring social order and are an alternative to, not an extension of, formal legal sanctions.

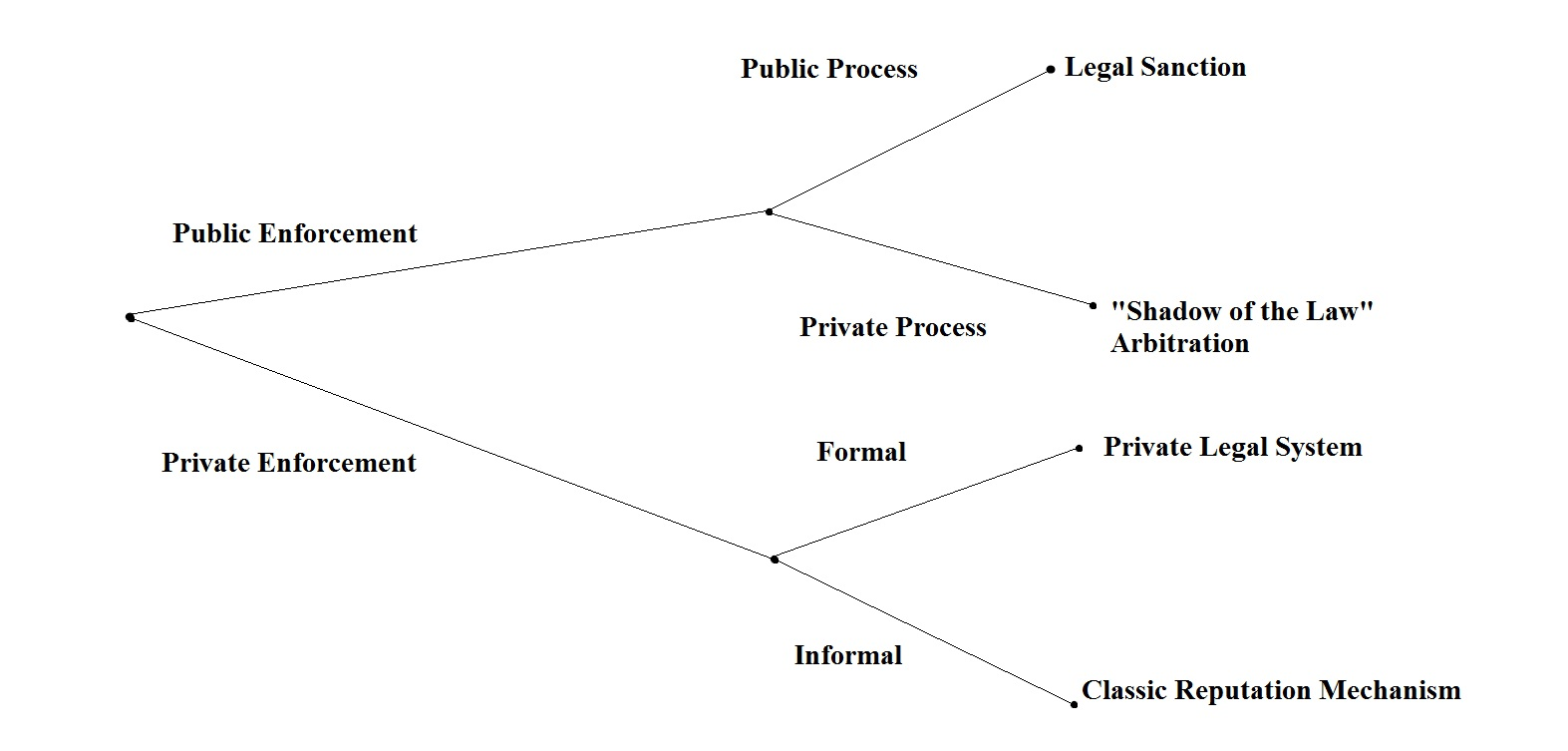
In this category of self-enforced agreements are private legal systems that arise where reliable state-sponsored contract enforcement is unavailable. Merchant communities that fall into the first category include those in early commercial societies, which predated modern state institutions and contract law,[[7]](#footnote-7) modern-day communities in third-world societies where contract law and independent judiciaries are not yet well developed,[[8]](#footnote-8) and members of mafia or other criminal networks whose transactions involve illegal activity (since state courts refuse to enforce contracts that involve illegalities).[[9]](#footnote-9) These commercial networks resort to self-enforcement because state contractual enforcement is not a reliable option. These merchant communities reveal insights into the ancestors of commercial societies and the utility of modern courts, and most scholars characterize these enforcement mechanisms as prelaw orders that are easily supplanted when reliable public ordering emerges.[[10]](#footnote-10)

Another category of private ordering mechanisms that belong in this area are private legal systems that are built atop industry-wide arbitration. In this species of arbitration, a particular merchant community, which often comprises an entire industry segment, deliberately declines to rely on available court remedies to enforce agreements. Lisa Bernstein is a leader in uncovering such systems, including those supporting the Diamond Dealers Club of New York,[[11]](#footnote-11) the National Grain and Feed Association,[[12]](#footnote-12) and the assorted trade associations that govern America’s cotton merchants.[[13]](#footnote-13) McMillan and Woodruff uncover similarly organized reputation systems that enforce agreements made to America’s fresh fish wholesalers and New York’s dress manufacturers,[[14]](#footnote-14) and more recent studies of kosher certification, food labeling, and eco-friendly accreditation.[[15]](#footnote-15)

This lattermost category of private legal systems has mistakenly been conceptually confused with more typical arbitration systems. Earlier scholarship praises these systems because they achieve lower adjudication costs than state courts, exhibiting more efficiency, speed, and accuracy. Because of these adjudication costs, scholars have argued that merchant communities develop private ordering specifically to capture these savings. Construction of a private ordering system, these works maintain, is thus a deliberate choice in that the state courts remain a viable but merely less preferable option, leaving private ordering in the “shadow” of otherwise enforceable law. Lisa Bernstein, for example, explicitly describes private legal systems as an “opting out” of state-sponsored dispute resolution. Scholars characterize private legal systems the same language, and as achieving the same purposes, as rudimentary arbitration agreements. In fact, these systems arise out of very different circumstances, achieve different efficiencies and objectives, and operate under a different theoretical framework.

A Simple Schema

How do enforcement costs relate to adjudication costs? In arguing that enforcement efficiencies determine the emergence of private systems, and that adjudication efficiencies are secondary, I propose the following sequential model:



Thus, although private legal systems are often characterized as arbitration systems with specialized law, in reality they are dramatically different from conventional arbitration. Private legal systems do indeed rely on arbitration, and they similarly are credited with developing specialized systems of substantive and procedural law. But both the arbitration and legal qualities of these systems belie the true economic (and often social and historical) forces that spawn their existence and create their efficiencies.

First, although private legal systems look like systems of law, they are more accurately described as information mechanisms. When transactional security relies on private enforcement, any formal adjudication that precedes the triggering of private sanctions is used only to prevent against the misuse of those sanctions. After all, no enforcement mechanism can be sufficiently credible to survive market forces if it does not inspire confidence with its accuracy.

Second, in contrast to the conventional wisdom, private enforcement cannot coincide alongside court ordering. Since any enforcement mechanism requires costs to implement, no system will survive relying on redundant costly mechanisms. Private and public ordering might coexist when private sanctions enforce transactions in the shadow of the law, but then the systems play different roles. In fact, a key feature of private sanctions appears to be the demand for exclusivity among repeat traders, and merchants who seek to invoke alternative enforcement mechanisms are often punished simply for going outside the clan.

Finally, enforcement—as a matter of simple logic—is the horse that pulls the cart. For this reason, we see mechanisms that reduce transaction costs, such as adjudication devices that promote accuracy or procedural devices that accelerate judgments, mimicked across systems. But enforcement mechanisms are replaced as one device achieves superiority over another.

Thus, although the schema is almost glibly simple, its emphasis on enforcement over adjudication and its illustration of how public and private systems relate to each other, poses deep challenges for conventional theory.

Three Strikes for the Current Theory

Three foundational mistakes are responsible for the conflating private legal systems with arbitration.

First, if the motivation behind private legal systems is to generate litigation efficiencies, then it is curious that they are so rare. It is almost beyond doubt that tailored law and streamlined procedures enable private legal systems to enjoy substantial efficiencies over public courts (and Lisa Bernstein’s research is responsible for carefully articulating many of these efficiencies), but why does economic research overwhelmingly indicate that reliable public courts are central to facilitating economic growth,[[16]](#footnote-16) and correspondingly, why did most instances of private ordering dissolve with the emergence of public courts?[[17]](#footnote-17)

Missing from conventional understandings of private legal systems is that, in addition to enjoying meaningful efficiency advantages over public courts, they also assume significant costs that public courts do not. These costs are unrelated, however, to the litigation process but instead involve the institutional efficiencies of enforcing contracts. Because private legal systems rely on sustained reciprocity, they offer credibility only to insiders and thus erect significant entry barriers to outsiders.[[18]](#footnote-18) The balancing of enforcement costs – the benefits of creating transactional security versus the imposition of entry barriers – determines the economic desirability, vis-à-vis alternatives, of private legal systems. It is for this same reason that some early systems of private ordering persisted into the modern age whereas most succumbed to the emergence of reliable state-sponsored courts.[[19]](#footnote-19)

The second mistake, following from the first, is that private enforcement necessarily follows tailored law. A group of merchants could develop its own specialized legal templates and use state courts to enforce arbitration decisions. More specifically, a merchant community could simply require all of its members to use contracts that, should a disagreement arise, compel disputing parties to use a private dispute-resolution forum with preselected arbitrators, industry-tailored law, and strict limitations on costly components of litigation such as discovery. Courts would uphold and enforce any conclusions by the arbitrators, and pursuant to the Federal Arbitration Act[[20]](#footnote-20) and similar state law provisions, courts would even stay any parallel litigation before them that is subject to an arbitration agreement.[[21]](#footnote-21) Consequently, the industry could leave enforcement entirely to state courts while maintaining a private legal forum. This would be the best of both worlds: all the administrative savings from the privately tailored substantive law and procedures, yet no need to rely on reputation mechanisms, nonlegal sanctions, or any other instruments of private enforcement that, necessarily, erect costly entry barriers. Given the costs to assuming private enforcement, why would private legal systems also institutionalize costly coordinated punishments rather than piggybacking off public courts?

However, examinations of private legal systems do not reveal any such mosaic of public enforcement and private dispute resolution. We instead observe private ordering accompanying private substantive law and with it the pervasive reliance on reputation mechanisms despite their significant costs. This is because administrative savings are only of secondary importance, where the primary factor driving parties towards private ordering is the ability of courts versus other instruments to enforce agreements. Enforcement costs determine the emergence of private legal systems, and administrative costs help shapes its countours.

The third error is the presumption that private legal systems can only function with arbitrators and well-developed private law. If private legal systems emerge because of administrative efficiencies, then it would be beyond imagination to have a legal system without any legal substance. It would be like agreeing to arbitration without identifying an arbitrator.

In fact, in parts of the diamond industry, with its private legal world made famous by Lisa Bernstein, disputes are privately resolved but without judges or law. Although Bernstein’s famous analysis of the New York Diamond Dealers Club describes a world of arbitration with clear substantive rules and clearly identified arbitrators and procedures, India’s diamond center is very different. Consider the following exchange:

Author: So what happens when merchants have a disagreement.

Merchant: They resolve it. They always want to work things out.

Author: But what happens when they can’t resolve it themselves, when there was a genuine misunderstanding or disagreement that has no easy compromise solution?

Merchant: Then they’ll find a senior, respected person in the industry and that person will resolve it.[[22]](#footnote-22)

India’s diamond center, located in Mumbia and with active trading and cutting throughout Gujarat province, handles 95% of the world’s diamonds. It is a budding center for the industry, whose significance is gradually overtaking New York’s and Antwerp’s. Yet there are no arbitrators and no binding arbitration. Parties simply resolve disputes on their own and establish their own order without any law.

Conclusion

1. Martin Shapiro, Courts, *in* 5 Handbook of Political Science 321, 321 (Fred I. Greenstein & Nelson W. Polsby eds., 1975). [↑](#footnote-ref-1)
2. Galanter criticism of “legal centralism,” (a label he borrowed from John Griffiths, What is Legal Pluralism?, 24 J. Legal Pluralism 1, 3 (1986)), targeted a “state-centered view of the legal phenomena,” in which scholars tend to discuss only those legal instruments found in public courts, to the exclusion of the broad array of private enforcement mechanisms. The onsloght of scholarship exploring private ordering and private legal systems might convince Galanter to temper his criticism. [↑](#footnote-ref-2)
3. Marc Galanter, Justice in Many Rooms: Courts, Private Ordering, and Indigenous Law, 19 J. Legal Pluralism 1, 17–21 (1981). [↑](#footnote-ref-3)
4. Robert H. Mnookin & Lewis Kornhauser, Bargaining in the Shadow of the Law: The Case of Divorce, 88 Yale L.J.950, 968 (1979). Robert Mnookin and Lewis Kornhauser are credited for popularizing the “shadow” metaphor. [↑](#footnote-ref-4)
5. Priest, Klein. [↑](#footnote-ref-5)
6. Niccoló Machiavelli, *The Discourses.* 1517. [↑](#footnote-ref-6)
7. See, e.g., Karen Clay, Trade Without Law: Private-Order Institutions in Mexican California, 13 J.L. Econ. & Org*.* 202, 202 (1997) (examining private contractual enforcement among Spanish merchants in 1830s California); Greif, Contract Enforceability, at 528–31 (same, for eleventh-century Mediterranean merchants); Greif, Reputation and Coalitions, at 860 (same); Milgrom et al., at 4–6 (modeling private adjudication system used by medieval European traders). [↑](#footnote-ref-7)
8. See, e.g., Marcel Fafchamps, The Enforcement of Commercial Contracts in Ghana, 24 World Dev. 427, 442–43 (1996) (discussing the limited role legal institutions play in enforcing contracts between Ghanaian firms); John McMillan & Christopher Woodruff, Dispute Resolution Without Courts in Vietnam, 15 J.L. Econ. & Org*.* 637, 640–41 (1999) [hereinafter McMillan & Woodruff, Vietnam] (describing the use of reputation mechanisms and private ordering to enforce contracts between Vietnamese businesspeople); Christopher Woodruff, Contract Enforcement and Trade Liberalization in Mexico’s Footwear Industry, 26 World Dev*.* 979, 984–85 (1998) (tracing the evolution of private contract enforcement in the Mexican footwear industry as trade barriers were liberalized). [↑](#footnote-ref-8)
9. See, e.g., Curtis J. Milhaupt & Mark D. West, The Dark Side of Private Ordering: An Institutional and Empirical Analysis of Organized Crime, 67 U. Chi. L. Rev. 41, 48–51 (2000) (arguing that organized crime provides “response to inefficiencies in the property rights and enforcement framework supplied by the state”); Richman, supra note, at 66 [↑](#footnote-ref-9)
10. See Avner Greif, Institutions and Impersonal Exchange: The European Experience 25–34 (John M. Olin Program in Law and Econ., Working Paper No. 284, 2004), available at http://papers.ssrn.com/sol3/papers.cfm?abstract\_id=548783 [↑](#footnote-ref-10)
11. Bernstein, Diamonds [↑](#footnote-ref-11)
12. Bernstein, Business Norms [↑](#footnote-ref-12)
13. Bernstein, Cotton [↑](#footnote-ref-13)
14. McMillan & Woodruff, Dysfunctional Public Order [↑](#footnote-ref-14)
15. Find cites. [↑](#footnote-ref-15)
16. .See, e.g., Douglass C. North, Institutions, Institutional Change and Economic Performance 110 (1990) (“We have long been aware that the tax structure, regulations, judicial decisions, and statute laws . . . determine specific aspects of economic performance . . . .”); Avner Greif & Eugene Kandel, Contract Enforcement Institutions: Historical Perspective and Current Status in Russia, *in* Economic Transition in Eastern Europe and Russia: Realities of Reform 291, 317–18 (Edward P. Lazear ed., 1995). [↑](#footnote-ref-16)
17. See Grief, Institutions… [↑](#footnote-ref-17)
18. Richman, Towards a Positive Theory of Private Ordering; Richman, The Antitrust of Reputation Mechanisms. [↑](#footnote-ref-18)
19. .A popular hypothesis that accompanied examinations of underdeveloped legal systems was that, in fact, relational contracting and private ordering would inevitably succumb to public courts. See, e.g., P.J. Fitzgerald, Salmond on Jurisprudence §§ 31–32 (12th ed. 1966); see also Cooter, Structural Adjudication, at 216 (“Many intellectuals believe that centralized law is inevitable, just as they once believed that socialism was inevitable.”). [↑](#footnote-ref-19)
20. .9 U.S.C. § 1 (2000). [↑](#footnote-ref-20)
21. .See id. § 3 (“If any suit . . . be brought in any . . . court[] of the United States upon any issue referable to arbitration . . . the court . . . shall on application of one of the parties stay the trial of the action until such arbitration has been had . . . .”); see also Gillian K. Hadfield, Privatizing Commercial Law: Lessons from the Middle and the Digital Ages 17 (Stanford Law Sch., John M. Olin Program in Law and Econ., Working Paper No. 195) http://papers.ssrn.com/sol3/papers.cfm?abstract\_id=220252(“‘Private’ arbitration is a creature of contract and so is as much a matter of ‘public’ law as any contract.”). [↑](#footnote-ref-21)
22. Interview, March 13, 2008, Diamond District, Mumbia, India [↑](#footnote-ref-22)