Rev Austrian Econ (2006) 19: 149–187
DOI 10.1007/s11138-006-7346-3

Contractual nullification of economically-detrimental state-made laws

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Abstract An economy may remain robust in the face of efficiency-inhibiting state-made rules if individuals are able to establish effective sources of credibility that do not rely on the state. After explaining how non-state sources of trust and private recourse evolve to enhance credibility, examples of contracting around undesirable rules in United States are discussed. The potential for contractual nullification varies considerably, however, in part because of state action that limits civil-society and/or market activities. In many less robust economies, there are even more significant barriers to building private sources of trust and recourse, undermining the potential for contractual nullification.

Keywords ADR · Contractual nullification · Credibility · Customary law · Private recourse · Reputation · Trust

JEL Code D230, K120, O170

1. Introduction

The ideal conditions for a free market never exist, since most if not all governments make many rules that can intentionally or unintentionally (perhaps arbitrarily) undermine property rights and limit competitive forces. When such rules are effective the economy within the affected jurisdiction can be severely hampered, losing its robustness, stagnating, and even declining (e.g., see de Soto 1989, 2000). In other jurisdictions, however, economies are strong enough to remain robust despite such government-made rules. It is widely recognized that freedom to contract is one of the important theoretical underpinnings of a free market that government law can either support or undermine. However, the ability to contract, perhaps even when government attempts to prevent it, also can be an important source of robust economic activity in political jurisdictions where government actions undermine theoretically ideal free market

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conditions. In particular, an economy can remain robust if individuals and groups are able to contractually nullify economically detrimental state-made rules by agreeing to recognize other rules. For instance, De Alessi and Staaf (1991) emphasize that the historic ability to contract around the rules implied by common-law decisions has been an important safeguard against judicial legislation and/or judicial error in the United States and other common law jurisdictions.[1] Contractual nullification can also apply to legislation, however. There are many examples of contractually established property rights to supposedly "publicly" owned lands, for instance (Umbeck 1981, Anderson and Hill 1979, 2004, de Soto 1989, Benson 1991a).

The potential for contracting around undesirable rules clearly varies across political regimes, of course.[2] It may be easier to nullify rules created in the relatively decentralized common-law process, for instance, than it is in relatively more centralized legislative processes. Perhaps more importantly, the promises that people make must be credible for contracting to be an effective option. Furthermore, one source of credibility is third party enforcement, so if the state is the source of such enforcement and if the state refuses to enforce contractually created rules of obligation that are in conflict with state-made positive-law rules, then contracting will not be an effective mechanism for nullifying undesirable rules. Significantly, however, recourse to third party enforcement is not the only source of credibility, and the state is not the only source of third party enforcement. Thus, an economy may remain robust in the face of efficiency-inhibiting state-made rules, and even in the face of state courts that refuse to enforce contracts that nullify such rules, if individuals are able to establish effective sources of credibility that do not rely on the state.

There would be no credibility problem if everyone had full knowledge, but such perfect knowledge does not exist anywhere except in some economists' mathematical models. Information is so scarce in the real world that trust or recourse generally must substitute for full knowledge in order to make contractual promises credible. Trust, a willingness to make oneself vulnerable to another even in the absence of external constraints, certainly can evolve to support contracting, as explained below, but it takes time, and under some circumstances it can be limited to relatively small communities. If individuals, in an effort to nullify state-made rules, are going to be willing to contract with others that they do not trust, then non-state sources of recourse in the form of credibly threatened sanctions against breaches of promises (perhaps supported by third party dispute resolution) are necessary substitutes. Section II of the following presentation considers non-state sources of trust and recourse.[3] Section III returns to the issue of contracting around undesirable rules with a discussion of some of the historical developments in the United States with its relatively long history of robust economic activity. While many commentators correctly point to the constraints placed on the state by the U.S. constitution, this section will illustrate that U.S. citizens also have always had the ability to develop various private mechanisms for trust creation and for re-

[1] In fact, De Alessi and Staff (1991: 112) argue that during much of common law history, the application of many potential precedents was determined voluntarily: "the *right to contract around the rule* indirectly yields unanimity: all those parties who do not wish to be bound by a particular rule . . . generally have the opportunity to adopt any other rule that is mutually satisfactory."

[2] In some cases, for instance, the contractually-created and privatized property rights to "public" resources can be quite secure, and the government may even feel compelled to recognize those rights, as with the gold mining claims on public land in California discussed below. In other cases the rights are quite insecure as the state is a constant threat to take them back. De Soto (1989, 2000) notes that the insecurity of squatter rights in Peru and other developing countries means that the property is actually "dead capital" in that it cannot be used as collateral for loans.

[3] Obviously, the legal systems of nation states are potential sources of recourse. Unfortunately, in many countries these legal systems do not provide consistent and predictable recourse, as discussed below.

course, often despite state efforts to prevent such developments. The ability to do so does vary considerably, however, even within the U.S., as noted in Section III. In some areas of law the potential for contractual nullification has been or is being limited by state action. The concluding section turns to other economies that do not share the United State's record of robust economic activity. Many of these states have adopted constitutions that compare to the one in the U.S. and implemented democratic institutions, but they do not have the same capacities for building private sources of trust and recourse to support contractual nullification.

2. Non-state sources of credibility in contracting[4]

Most arguments about the inability of private parties to contract without the backing of a coercive power are explicitly or implicit prisoners' dilemma arguments. The one-shot prisoners' dilemma analogy does not characterize many kinds of interactions, however, and when this is the case, contracting without state backing becomes possible because backing may be provided as a result of trust relationships or private sources of recourse.

Building trust. Many of the concepts from game theory are useful in demonstrating the potential gains from cooperating and/or defecting in various contexts, and therefore, in thinking about determinants of trust [e.g., see Axelrod (1984), Ellickson (1991), Ridley (1996), Vanberg and Congleton (1992)].[5] Game theory demonstrates that cooperation can arise through repeated interactions, for instance (Axelrod 1984). As an example, consider McMillan and Woodruff's (1998) study of emerging trade in Vietnam. They explain that an entrepreneur tends to be very cautious when considering a potential trading partner. A Vietnamese entrepreneur often visits the plant of the firm he is considering dealing with 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 involve a substantial commitment. As a result, building trust can take time. Furthermore, because the long-term reciprocal response is uncertain, a repeated-game situation does not guarantee unconditional cooperation even with tit-for-tat threats to reinforce the positive incentives associated with remaining on good terms with the other party(ies) (e.g., relatively secure property rights, the potential to focus resources to produce wealth rather than violence). The dominant strategy still depends on expected payoffs, frequency of interaction, time horizons, and other considerations (Tullock 1985: 1073; Ridley 1996: 74–75; Rutten 1997). Thus, building trust through the development of repeated interaction relationships is both uncertain, and potentially quite slow.

Individuals may be able to gain the trust of others relatively quickly by offering some sort of bond or hostage (Williamson 1983). When an unknown party posts a bond with some trusted third party (e.g, a reputable bank) as a guarantee that his promises are credible, for instance, he may be able to overcome a lack of trust. Similarly, individuals can invest

[4] This section draws from Benson (2001, 2005).

[5] North (1990: 15) explains that game theory "does not provide us with a theory of the underlying costs of transacting and how those costs are altered by different institutional structures." An understanding of the evolution of rules and property rights really requires consideration of the factors that lead to a transition from one institutionalized game setting to another and another and so on, as suggested below, rather than the analysis of a particular game. Thus, game theory can only serve as a supplement to the more fundamental institutional analysis outlined here.

in signals that demonstrate a commitment to cooperation. Essentially, investments in non-salvageable assets are offered as a bond to insure credibility.[6] Information transmission is a key to the success of such a strategy, as potential contractual partners must be aware of such commitments. If they are, then the marginal cost to contractual partners of measuring such specialized or non-salvageable investments must also be less than the prospective gains. As Klein and Leffler (1981) explain, in the context of their discussion of such investments as a means of guaranteeing quality products, for instance: "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" he or she will tend to trust the seller. When effective recourse is not available or is relatively costly, individuals who want to enter into cooperative relationships such as trade or rule nullification have very strong incentive*s* to make such investments. Time is required to build reputations through these kinds of processes too, of course, so individuals who want to enter attractive contractual arrangements may have to suffer through a considerable period of losses before they can expect to see investments in reputation building pay off. Indeed, since the payoff to such investments are delayed and very uncertain, incentives to make them tend to be relatively weak, and the emergence of cooperation based on such sources of recourse also can be quite slow.[7] There is another alternative as well.

Markets for reputation can also develop. For instance, a firm or other organization might develop a reputation for honestly assessing the quality of other firms' products or services. Then when someone wants to quickly establish a reputation, he or she can pay for an inspection/test (e.g., of a product or service performance, financial records, other records of relevance) and "certification" by this reputable assessment organization (Carter and Manaster 1990, Anderson, et al. 1999). Moodys, Standard and Poors, Underwriters Laboratory and the Good Housekeeping Seal of Approval, and the American Automobile Association's ratings of motels come to mind. This is not just a process for firms to establish reputations relatively quickly, however. Charitable organizations also can seek certification from the American Institute of Philanthropy or Charity Navigator, for instance, in order to demonstrate the credibility of their commitment to operate relatively efficiently and spend funds as promised.

[6] For instance, Klein and Leffler (1981, also see Shapiro 1982, 1983, Diamond 1989) discuss investments in visible non-salvageable assets in order to guarantee quality. As an example, consider Nelson's (1974) explanation of advertising of experience goods. He notes that such advertising 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. 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. Investments in other non-salvageable assets (e.g., elaborate store fronts, charitable contributions, community service) can serve the same function.

[7] Some individuals may have reputations that they have developed in other activities, however, that can be transported into the new situation. Firms with international reputations may enter an emerging market and become established very quickly, for instance. Similarly, many on-line retailers have pre-existing off-line reputations. These firms are relatively likely to be able to establish profitable on-line businesses relatively quickly. New retailers who only operate on line face higher costs as they attempt to establish credibility (Benson 2005). Thus, for instance, a 2004 survey of on-line retailers found that 93 percent of the firms who had on-line web sites as well as off-line catalog business reported making a profit, as did 85 percent of the traditional retailers (i.e., firms with real-space retail stores) who had established web sites (Tedeschi 2004: 1). On the other hand, only 67 percent of the retailers who sell exclusively through the internet, described as a group "still struggling to achieve profitability," reported profits, and many of them had suffered substantial losses the year before (Tedeschi 2004: 1).

The market for certification appears to be particularly important in the emerging cyber economy (Benson 2005), so it could be in other emerging economies if government actions do not stand in the way. For instance, VeriSign Inc. is a leading supplier of encryption technology and public key arrangements. In addition to supplying the encryption/public-key services, VeriSign 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" which is 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.[8]

Certification does not completely solve the assurance problem, of course, since potential contracting partners must trust the supplier of certification. However, as Hadfield (2000: 29) notes, such certification options takes a credibility problem that may involve large numbers of individuals "and folds them back to a commitment problem for a single entity." After all, the value offered by certification companies is their ability to provide secure systems and their reputation for providing audits and revocations of certification from customers who fail to meet their security requirements.[9]

Reputation can be purchased in other ways as well. One possibility is to contractually affiliate with an organization that is recognized to require that all affiliates meet specified standards for their products or services. Best Western Motels are an example. Locally owned franchises of regional or national chains of motels, restaurants, retail outlets, and so on provide other examples. Charities that join the United Way organization also have to meet various standards. All such arrangements involve non-salvageable investments, of course, since failure to maintain quality will result in loss of the reputation signal that has been purchased.

[8] Certification of quality and performance standards is also available in cyberspace (Hadfield 2000: 32–35; Kesan 2003: 101). Several suppliers of certification have developed. For instance, the American Institute of Chartered Public Accountants and the Canadian Institute of Chartered Accountants (AICOA/CICA) offer a WebTrust program. This combined group established procedures for auditing on-line business practices regarding privacy, security, and the handling of complaints about quality and performance. Firms that obtain a favorable report from a CPA or CA with a WebTrust license, are issued an Enrollment Identification (EID) that allows them to apply for certification by a private firm like VeriSign that has an agreement to manage a WebTrust seal. Clicking on the seal takes the user to the certificate and the accounting report. Periodic audits ensure continuing compliance. Similarly, BBBOnline offers a "Reliability seal" to certify that an on-line business is "reliable" and "trustworthy." Benson (2005) discusses other examples of on-line certification processes.

[9] Product and service quality are not the only credibility issues that can be resolved through certification. For example, certification procedures can alleviate privacy concerns that arise in cyberspace. A group of internet firms, including Microsoft and AOL have started a organization called the Online Privacy Alliance. This group, in conjunction with the Electronic Frontier Foundation (a non-profit organization promoting freedom of expression in cyberspace, and funded by founders of Lotus Development Corporation and Apple Computers) and The Boston Consulting Group, started TRUSTe, a non-profit corporation which has established a set of practices regarding respect for user privacy, and which provides a "trustmark" to internet sites that adopt those practices (Hadfield 2000: 30). TRUSTe performs audits of sites to make sure that they adhere to the practices. Certified sites have seals that, when clicked, takes users to the sites' privacy statements, as well as "click-to-verify" seals that take the user to TRUSTe's secure server where the seal is authenticated. TRUSTe monitors compliance through regular reviews and by submitting user information containing identifiers that are then tracked through the firm's system. In addition, it has a "watchdog" site where users can report privacy-policy violations and other concerns.

A related phenomena involves independent specialists in gathering and selling information. Some firms or organizations gain reputations by specializing in examining products, services, financial practices or other relevant credibility factors and providing their independent assessments, for example. Credit-reporting organizations provide information about potential debtors to potential lenders [see Klein (1992) for relevant discussion], for instance. Similarly, Consumer Reports tests and reports on products, and there are many other specialists in evaluation and recommendation (e.g., restaurant, movie and Broadway critics; travel magazines and books; rankings of colleges and graduate schools). Individuals who want to build reputations may pursue endorsements from such independent evaluators.[10]

From trust and reputation to recourse. When repeated dealing arrangements are valuable, each individual has implicit threat of punishment if the other party fails to live up to a promise, commits fraud or behaves opportunistically: the tit-for-tat response. As more bilateral relationships are formed in recognition of the benefits from cooperation, a loose knit group with intermeshing reciprocal relationships often begins to develop, however. An exit threat becomes credible when each individual is involved in several different games with different players, in part because the same benefits of cooperation may be available from alternative (competitive) sources (Vanberg and Congleton 1992: 426). In fact, individuals are generally involved in several "communities" as described by Taylor (1982: 26–30), wherein "the relations between members are direct and . . . many-sided" [also see Ellickson (1993)], and in such communities a tit-for-tat becomes a less significant threat. When competitive alternatives within a community of transacting individuals make the exit option viable, Vanberg and Congleton (1992: 421) suggest that one strategy that can be adopted is unconditional cooperation until or unless non-cooperative behavior is confronted, and then imposition of some form of explicit punishment of the non-cooperative player as exit occurs. They label such a strategy as "retributive morality," and the "blood-feuds" of primitive and medieval societies provide examples of such behavior. This practice of retributive morality strengthens the threat to non-cooperative behavior. However, the fact is that retributive morality or the blood feud played a much less significant role in primitive and medieval societies than is popularly perceived (Benson 1991a, 1994). After all, such violence is risky, and there is an even better alternative.

When individuals cooperatively engage in successful bilateral relationships within an evolving web of such relationships, others are likely to notice their cooperative behavior and attempt to initiate mutually beneficial relationships with them. In other words, when information about cooperation spreads, such behavior in one relationship can serve as investment in building a reputation for fair dealing, and this reputation can attract more opportunities. Importantly, however, when information spreads about non-cooperative behavior, all of the

[10] Online specialists in the supply of information have developed, and some companies seek endorsements from these sources. Some firms send free products to prominent reviews on sites like Epinions.com and Slashdot.org, for instance, even though the reviewers have no official status or credentials. These forums have developed methods for measuring the reputations of their review contributors, and some, such as Epinions, actually pay small fees to reviewers, determined by how readers react to the reviews (e.g., do they click over to the company's web page or go on to read other reviews?) (Thompson 2003: 2). Epinions also allows users to comment on individual reviews as well as on products, and teams of experienced users of the site are enlisted as monitors to detect efforts by a producer or employ to "plug" a product. Similarly, Slashdot measures how frequently a person contributes and how valuable other users feel that contributions are, and then gives each user a "karma" rating that determines their access to some of the site's privileges. The eWatch site monitors and tracks companies' on-line reputation "in thousands of locations in cyberspace including online media, chat rooms and bulletin boards" (Hadfield 2000: 34). The site also offers services to companies, in that its CyberSleuth program will attempt to determine the source of negative online statements about companies and recommend solutions.

beneficial relationships that the non-cooperative individual enjoys within the community can be put in jeopardy. All members of the community have an exit option, and therefore they may cut off all relationships with someone who has proven to be untrustworthy in dealings with anyone else in the group. This means that there is a low cost option to retributive morality: unconditional cooperation whenever an individual chooses to enter into some form of interaction, along with a refusal to interact with any individual who is known to have adopted non-cooperative behavior with anyone in the group and the spread of information about untrustworthy people. Vanberg and Congleton (1992) refer to this response as "prudent morality," and given that reputation information spreads quickly within a group, the consequences of retributive and prudent morality become quite similar. If everyone spontaneously responds to information the result is social ostracism, a very significant punishment, even though it is not explicitly imposed by a single retributive individual. Essentially, each individual's reputation is "held hostage" by every other individual in the evolving group, a la Williamson (1983), and reputation is an ideal hostage. It is highly valued by the individual who has invested in building it, so a credible threat of destroying it can be a significant deterrent, and the threat is also credible because the reputation hostage has no value to the hostage holder and the cost of destroying it (spreading truthful information) is low. That is, it is a non-salvageable asset (an asset that might be built relatively quickly by offering bonds or investing in even more non-salvageable assets, as noted above, thus increasing the value of the hostage). Such an ostracism threat can be a very powerful source of recourse. The "third party" providing the threatened sanction is the community of individuals who receive and respond to the information about non-cooperative behavior.

Complete ostracism need not occur based on one negative report of bad behavior, of course, as the target of the negative information may deny it, and the third party (the rest of the relevant community) must then decide which party's claims are credible. After all, one incident with negative feedback can represent a misunderstanding and even a false accusation. Naturally, a substantial amount of positive information can counter a small amount of negative information (Resnick, et al. 2003). For instance, Cabral and Hotacsu (2004: 19) note, in their study of eBay's reputation mechanism, that "Many times, when an eBay seller receives a negative comment, there is a 'war of words' between the seller and the buyer who places the negative. During this 'war of words,' the two parties can give several negatives to each other within a period of two or three days." Such contradictory information can be difficult for other parties to assess. Not surprisingly, dispute resolution mechanisms evolve to offer alternatives to destructive "wars of words" or more violent confrontations, as explained below. However, if there is corroboration ostracism does occur. For instance, Cabral and Hortacsu's (2004: 1–2) empirical analysis concludes that sales, prices, and survivability vary significantly across eBay sellers, depending on their feedback records, with negative feedback producing significant "punishment": "the growth rate of a seller's transactions drops form 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." Exit implies that the party cannot find people willing to trade at prices that will cover costs.

The spontaneous development of ostracism illustrates another point. As an informal community evolves from a web of bilateral trust relationships, community-wide norms also evolve. Note, in this context, that it is not the existence of "close-knit" communities that generates group-wide norms, as some have contended. Instead, norms and communities can evolve simultaneously as each affects the other: the evolution of norms of cooperation lead to the development of a web of interrelationships that can become a "close-knit" community,

and the development and extension of such a community in turn facilitates the evolution of more effective norms (Benson 1999a). Thus, as Vanberg and Congleton (1992: 429) conclude, perceptions "of what is moral vary with relevant differences in exit costs. At the high-cost end of the spectrum, moral justification for tit-for-tat and retributive behavior seems to be fairly common, whereas prudent morality gains in importance as we move to the low-cost end."

Many group-wide norms are simply commonly adopted behavioral rules that have been voluntarily (contractually) adopted to apply for a particular kind of interaction in a web of relationships. As this web of relationship becomes a community, other rules can arise. Called "solidarity rules" by Vanberg and Buchanan (1990: 185–186), these are expected to followed by all members of the group, because individual sacrifices associated with obeying solidarity rules produces shared benefits within the group (Vanberg and Buchanan 1990: 115). Solidarity rules are things like "do not behave recklessly and put others at risk." However, they can also involve rules about individuals' obligations in cooperative production of rule-enforcement functions. Rules like "inform your neighbors about individuals who violate norms and contractual obligations," and "do not cooperate with individuals who behave in a non-cooperative fashion with someone else," are solidarity rules in the sense that production of information and ostracism create benefits for everyone in the group by deterring non-cooperative behavior.

Significant limits on abilities to reason and to absorb knowledge means that individuals are not able to use conscious reason to evaluate every particular option in the array of available alternatives (O'Driscoll and Rizzo 1985: 119–122; Hayek 1937, 1973). Therefore, rational individuals will often find it beneficial to voluntarily conform to a community's rules in an almost unthinking way. And in this context, as Ridley (1996: 132) notes, "Moral sentiments . . . are problem-solving devices [that evolve] . . . to make highly social creatures effective at using social relations [by] . . . settling the conflict between short-term expediency and long-term prudence in favor of the latter." People conform to all sorts of faddish and ritualistic behaviors, of course, and even though they may appear to have nothing to do with evolving norms or moral sentiments, they actually may have similar functions: facilitating cooperation. After all, while individuals want to identify and exclude non-cooperative players, they also have strong incentives to identify themselves as cooperative (Ridley 1996: 139). Outward conformity to a group's fads and rituals can serve as a signal of willingness to cooperate in order to be in a position to reap the rewards from participation in joint production and other forms of mutually-beneficial interaction within the evolving group. As Ridley (1996: 188) explains, "We are designed not to sacrifice ourselves for the group but to exploit the group for ourselves."

Incomplete knowledge, scarcity, and transaction costs mean that someone alleged to have violated a trust or solidarity rule may not be guilty, as noted above, so "disputes" over guilt or innocence arise. Indeed, confrontations can arise under two different conditions in an expanding or increasingly dynamic group. In addition to disputes regarding allegations of violations of a norms, disputes can arises when property rights that are not clearly defined become valuable and conflicting claims to those rights are asserted. In this context, for instance, all contracts are necessarily incomplete in the sense that the contracting parties cannot anticipate all potential contingencies that might arise in the uncertain future. Thus, if an unanticipated change creates strong incentives to breach the contract, the promisee sees his entitlement to performance (right to receive performance) as threatened, while the promisor may feel that the entitlement does not exist under the new circumstances. A dispute arises. Most disputes, particularly over contracts (including the implicit "social contract" of a close-knit community), can be solved by direct bargaining, but transaction costs

can prevent successful bargaining is some cases. Therefore, third-party dispute-resolution institutions are desirable in order to reduce the chances of violent confrontation (violence can be a dispute resolution process but it can create considerable costs for other members of a community), and to increase the chances that the community can survive so its members can prosper from the mutually beneficial interactions it supports. Public courts are one source of such dispute resolution, of course, but there are many other options as well. Contracting parties can specify some sort of alternative dispute resolution (ADR) for instance, be it mediation, arbitration, or some combination of the two. Individuals may also choose ADR after a dispute arises, even if they have not specified the option in a formal contract, possibly because doing so is required by a solidarity rule within the community, or simply because they want to maintain a good relationship with other community members.

Third party dispute resolution. Voluntary acceptance of ADR means that the selected third party must be acceptable to both disputants, so "fairness" is embodied in the dispute-resolution process. There are a wide variety of potential sources of ADR. Specialists can be selected from organizations like the International Chamber of Commerce, the American Arbitration Association, or any number of other private dispute resolution providers, including private ADR firms and for-profit "courts."[11] Mechanisms for ADR (e.g., arbitrator and mediator) selection actually vary widely, but they all are designed to guarantee the selection of an unbiased third party who will apply the norms that the parties share within their relevant community.[12]

In general, the choice of an ADR provider is made without requiring explicit agreement by the two parties while still allowing for prescreening, and possibly more than one level of screening (Benson 1999b, 2000a). For example, one common selection method involves a pre-approved list of mediators or arbitrators determined by contracting parties (or their community organization, as suggested below), so if a dispute arises, a person is chosen from the list by some preset mechanism (e.g., random selection, rotating selection, selection by a third party such as a governing board of a trade association). Another common arbitrator selection system gives the parties to a dispute the resumes of an odd numbered list of arbitrators from a larger pre-selected group (e.g., pre-selected by a community such as a trade association, as noted below, or provided by an organization like the ICC or the AAA), with each party having the power to successively veto names until one remains. Thus, a second level of screening is added at the time of the dispute, contributing "to the legitimacy of the arbitrator and his award in the eyes of the parties" (Bloom and Cavanagh 1986: 409). Since the parties are given the arbitrators' resumes, they have information about experience, training, the nature

[11] See for example, Phalon (1992), Ray (1992), and Benson (1998c) for discussion of the developing private-for-profit court industry in the United States.

[12] There also is considerable variation in the institutional arrangements themselves. Some communities rely almost exclusively on mediation backed by social pressure to voluntarily reconcile differences [e.g., see the following discussion of the Quakers and some of the other religious based groups in early America]. Others appear to rely more heavily on arbitration. The preceding statement includes the word "appear" because it may be that mediation efforts are informal, so they are not easily observed, while arbitration arrangements are more formal and they can be open to public observation. Indeed, arbitration often can be quite "public" when community backing is required, as for instance, among the Yurok and other Native American communities of Northern California during the early nineteenth century (Benson 1991a), Anglo-Saxon communities (Benson 1994), and historical commercial communities (Benson 1989). Of course, arbitration can also be very private, as in many modern commercial situations, for reasons such as those discussed in Benson (1999b, 2000a). Many communities probably employ a combination of mediation and arbitration. Diamond merchants mandate that disputes go through a conciliation (mediation) process before they can go to arbitration, for instance, and most disputes are actually resolved through this consolidation process (Bernstein 1992). Arbitration arises only when mediation clearly cannot achieve a solution.

of awards given in the past, and so on. A similar practice provides the parties with a list and resumes of an odd number of potential arbitrators from a pre-approved list, with each disputant having the power to veto one less than half and rank the others, and the arbitrator who is not vetoed by either party and has the highest combined rank is chosen. Both sides of the dispute may also provide a list of a fixed number of mediators or arbitrators with each being able veto any or all of the names on the other party's list; if all names are vetoed each provides another list and the process is repeated (clearly, this procedure requires that both parties want to arbitrate, so they do not continue to provide unacceptable names). All such systems are intended to guarantee the appointment of an third party without requiring explicit agreement by the two parties while still allowing for prescreening, and possible more than one level of screening, of the potential mediators or arbitrators. Empirical evidence indicates that selection of arbitrators for a pre-approved list is based on the reputation of the arbitrators for impartiality and expertise in contractual matters that might arise (Ashenfelter 1987; Bloom and Cavanagh 1986).

Biased rulings are not likely in such a competitive environment where potential arbitrators are chosen beforehand by the community (e.g., as in the diamond traders associations) or where both parties have the power to reject judges proposed by the other party. Furthermore, successful arbitrators will be those who consistently apply the norms that the members of the relevant community expect to be applied. Indeed, by choosing an arbitrator/mediator attempting to build a reputation of trustworthiness, strong incentives are created for those aspiring to be chosen to avoid the appearance of bias. The chosen arbitrator/mediator must convince individuals in the group that a judgement should be accepted, after all, since he has no coercive power to enforce it. More importantly, an appearance of bias will damage the individual's reputation. The ruling can therefore be backed by an implicit threat of ostracism, although in general, dispute resolutions are likely to be accepted because individuals recognize the benefits of behaving in accordance with community members' expectations, not because they fear ostracism (Pospisil 1971, Benson 1989, 1991a).

Recourse through contractual associations. 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 into informal communities. Potential contractual arrangements are numerous, including the implicit contracts of family bonds and ethnic or religious networks, clubs and other social organizations, and in the commercial area, arrangements such as indirect equity ties through pyramidal ownership structures, direct equity ties, interlocking directorates, and trade associations. As Khanna and Rivkin (2000) explain, for instance, business groups are actually "ubiquitous in emerging economies" (as evidence, they cite a large number of studies about groups such as *grupos* in Latin America, business houses in India, and *chaebol* in Korea). Many of these associations may form for reasons other than the development and enforcement of non-state-backed norms, of course, but once they develop, the cost of adding such functions is relatively low. In addition to creating strong bonds that facilitate interaction, an affiliation with such a group can be information generating in that it can imply a credible signal of reputable behavior.

A contractual organization 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 contractual community. Then group membership can include a contractual obligation to boycott anyone who fails to follow the group's contractually accepted rules: specifically, any non-cooperative party will be automatically expelled from the organization. Such automatic ostracism penalties make the reputation threat much more credible (Williamson 1991: 168).

These groups can also lower transaction costs by establishing their own unbiased dispute resolution arrangements, as suggested above. After all, allegations of non-cooperative behavior are not necessarily true, so they may have to be verified. Within some organizations a single mediator or arbitrator or panel of mediators or arbitrators is chosen for a set period to arbitrate all disputes between members. For instance, in the diamond industry, arbitrators are elected from the organization's membership (Bernstein 1992: 124–125). In many religious organizations, priests or elders provide this function. Those selected are likely to have considerable standing (reputation) within the community, and they have strong incentives to maintain their own reputation for fairness, so they are not likely to be biased or easily corruptible. These services do not have to be produced internally, however, as the group may contract with external ADR specialists.

When a dispute involves new and unanticipated issues, an ADR supplier may be required to determine what rule should be applied to the situation. In this context, for instance, Lew (1978: 589) explains that "Owing no allegiance to any sovereign State, international commercial arbitration has a special responsibility to develop and apply the law of international trade." The "law" that dominates international trade has, for the most part, evolved through contracting and the use of arbitration (Benson 1989, 1998a, 1998b, 1999b, 2000).

Customary Law. In modern societies the most visible types of rules are the "laws" designed and imposed by the various recognized government authorities within nation-states, but as noted above, there are other rules (e.g., habits, conventions, norms, customs, traditions, standard practices, contractual promises) that actually can be much more important determinants of behavior in many aspects of human activity. Indeed, the contention here is that they can nullify state-made rules. A key distinguishing characteristic of such rules is that they are initiated by either a unilateral or multilateral (e.g., contractual) decision to behave in particular ways under particular circumstance. As Hayek (1973: 97–97) emphasizes, adopting a behavioral pattern creates expectations for others who observe it and this create an obligation to live up to those expectations. Furthermore, as Mises (1957: 192) explains, when individuals who interact with one another observe each others' behavioral patterns they often emulate those that appear desirable, so such behavior and accompanying obligations spread. In other words, these rules evolve spontaneously from the bottom up rather than being intentionally designed by a legislator, and they are voluntarily accepted rather than being imposed. No central "authority" with coercive powers is necessary to produce the resulting cooperative social order, as obligations are largely self-enforcing: it pays for each party to behave as expected in order to be able to expand wealth over the long run through mutually beneficial interaction. When such self-enforcing incentives prove to be insufficient, however, community sanctions (e.g., ostracism) can also be applied.

Pospisil (1971, 1978) distinguishes between "legal" arrangements that evolve from the top down through command and coercion, which he calls "authoritarian law," and systems of obligations and solidarity rules that evolve from the bottom up through voluntary interaction, which he refers to as "customary law" (also see Fuller (1964, 1981)).[13] Such a norm-based cooperative arrangement often can be characterized as a "legal system" following Hart's (1961) definition of law, since, as implicitly suggested above, it has primary rules of obligation (e.g., recognized norms), and it can be backed by secondary rules or institutions of recognition (e.g., reciprocities, mechanisms to spread information about reputations, ostracism, mutual

[13] The term, customary law, is problematic, of course, because, as Pospisil (1978) explains, it has more

insurance, cooperative policing),[14] adjudication (e.g., negotiation, arbitration, mediation), and change (e.g., individual or contractually agreed upon innovations in behavior followed by observation, emulation and conformity; dispute resolution can also suggest new behavioral rules that can be emulated and conformed to).

For an obligation to achieve the status of a "customary law" it must be recognized and accepted by the individuals in the affected group. In other words, a strong consensus rule applies, and as a result, customary law tends to be quite conservative in the sense that it guards against mistakes. Nonetheless, flexibility and change often characterize customary law systems (Popisil 1971, Benson 1989, 1998a, Trakman 1983). For instance, if conditions change and a set of individuals decide that, for their purposes, behavior that was attractive in the past has ceased to be useful, they can voluntarily devise a new contract stipulating a new behavioral rule. Thus, an existing norm (custom) can be quickly replaced by a new rule of obligation toward certain other individuals without prior consent of, or simultaneous recognition by, everyone in the group. Individuals entering into contracts with these parties learn about the contractual innovation, however, and/or others outside the contract observe its results, so if it provides a more desirable rule than older custom, it can be rapidly emulated.

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than one definition. In much of the literature on positive law, the term refers to rules that are not codified and have been relied upon by the members of a group, unchanged "from time immemorial." Customary underpinning of the common law are often treated in this way by judges, for instance. This definition is highly questionable whenever a careful study of the origins of customary law is performed, however, because customary norms can actually evolve quite rapidly (Pospisil 1971; Benson 1989, Trakman 1983). A second and more complete definition was used by the Commentators of Roman law in the thirteenth and fourteenth centuries. The Commentators also emphasized *longa conuetudo* or long use, a questionable criterion for reasons just noted, but "Their second criterion, however, seems to be much more significant for scientific research. *Opinio necessitatis*, the requirement that, to be regarded as customary, a law must be backed by the people's 'conviction of its indispensability' and desirability . . . , brings out the basic characteristic of the term" (Pospisil 1978: 63–64). In other words, the vast majority of the people in a group view a customary rule to be binding and desirable, so the rule is "internalized" as if through a voluntary contract. Thus, such a rule guides everyone's actions within a group and makes behavior relatively certain or predictable. Fuller (1981: 213) explains that,

> To interact meaningfully men require a social setting in which the moves of the participating players will fall generally within some predictable pattern. To engage in effective social behavior men need the support of intermeshing anticipations that will let them know what their opposite members will do, or that will at least enable them to gauge the general scope of the repertory from which responses to their actions will be drawn. 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, a prohibition of certain disapproved actions, but of this negation, the meaning it confers on foreseeable and approved actions, which then furnish a point of orientation for ongoing interactive responses.

This view of customary law is adopted here, with the added condition that the customary norms are supported by processes of adjudication and change, a la Hart (1961), as discussed below. After all, Hart (1961: 97) includes "customary practice" as one possible "authoritative criteria" of legal validity (i.e., "rule of recognition"). Hart probably is using the term as in the first definition listed above, of course, but the contention here is that general acceptance implies validity, as do institutionalized means of spreading information about misbehavior, and of ostracism.

[14] Positive incentives to recognize such rules are strong because they arise voluntarily through mutually-beneficial interactions. Incentives to violate some of these rules can arise under some circumstances, of course, but negative incentives also arise through the threat of spreading of information about misbehavior and the resulting ostracism. Since solidarity rules produce benefits for everyone in the group, free-rider incentives arise, just as with any other jointly produced products. However, free riding is successful only to the extent that a free rider cannot be excluded from consuming benefits. Thus, as solidarity rules develop, the scope of the ostracism solidarity rule itself is likely to expand to include "do not interact with anyone who does not obey other solidarity rules." Therefore, solidarity rules are not public goods, as non-free riders are the only members of a group who are likely to retain membership in a customary-law community.

Contracting may actually be the most important source of new rules in a dynamic system of customary law (Fuller 1981: 157). For instance, many innovations in commercial norms are initiated in contracts and dispersed quickly through the relevant business community (Benson 1989, 1998a).

Contractual and customary processes can easily become intertwined. 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." Indeed, Fuller (1981: 176) argues that a sharp distinction between custom and contract is inappropriate:

> 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 question. In such a case it is difficult to know whether to say that by entering a particular field of practice 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.
>
> The meaning of a contract may not only be determined by the area of practice within which the contract falls but by the interaction of the parties themselves after entering the agreement. . . . The meaning thus attributed to the contract is, obviously, generated through processes that are essentially those that give rise to customary law. . . . [In fact,] a contract [may be implied] entirely on the conduct of the parties; . . . 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.

In essence, individuals are able to establish their rules of obligations toward one-another through practice and observation or through negotiation and explicit agreement. Thus, customary legal arrangements may be predominantly contractual. In fact, one reason for development of contracts in a customary law system is that individuals often base their expectations of how others will act, and determine how they should act, through observation of passed events. The resulting norms tend to be backward looking. Third party dispute resolution also tends to be backward looking. Arbitrators often justify their decisions by placing them in the context of past practices, for instance, in order to maintain a continuity in the law: custom and tradition rule. Therefore, if these were the only means of legal change, customary law might evolve very slowly. Certainly, customary law does tend to be conservative, but contracts provide a source of forward-looking voluntary legal change that can produce rapid but beneficial alterations in the status quo.

The expanding use of contract and development of contractual arrangements is, in fact, a natural event in the evolution of customary law. As customary legal arrangements evolve and are improved upon, they tend to become more formal, and therefore, more contractual. In addition, as a group develops and expands so that the trust relationships that characterize small group interaction do not apply, conflicts are avoided by explicitly stating the terms of the interaction *a priori*; that is, by contracting. A carefully constructed and enforceable contract can substitute for trust. Thus, with the evolution of contracts and enforceable dispute resolution mechanisms, the original bases for trust rules become relatively less important and the group can grow beyond the bounds of bilateral trust and even reputation mechanisms. Indeed, inter-group interaction can arise, given inter-group acceptance of contracts and dispute resolution.

As conditions change, the inadequacy of existing customary rules also can be revealed when a dispute arises. Negotiation is probably the primary means of dispute resolution for members of a customary law community, reinforcing the contention that contracting is a primary mechanism for initiating potentially rapid change in customary law. If direct negotiation fails, however, the parties to a dispute often turn to an arbitrator or a mediator. Since a dispute can suggest that existing rules are unclear or insufficient, new customary rules

can be and often are initiated through third-party dispute resolution (Fuller 1981: 110–111, Lew 1978: 584–589, Benson 1989, 1998a). Such a decision only applies to the parties in the dispute, but if it effectively facilitates desirable interactions the implied behavior can spread rapidly through the community, becoming a new rule.

No community evolves in complete isolation. Anthropological and historical evidence suggests that intra-group conflict has been an almost ubiquitous characteristic of human history, of course. Since a key function of customary-law communities is to establish and secure private property rights, and such rights are insecure if outsiders are able to "invade" and take the property, one joint product of a cooperative group is likely to be mutual defense. In fact, an external enemy can strengthen group cohesion (Wesson 1978: 184, Ridley 1996: 174), leading some to actually suggest that norms are important because they enable groups to be sufficiently united to deter their enemies, not because they allow people to create order (coordination) within their groups (Alexander 1987). Clearly, norms that support the production of mutual defense evolve, and an important part of an individual's belief system will be a "communitarian" one (e.g., tribalism and "a concept of them and us" where individuals are expected to aid in the defense of the "community"). In fact, however, these communitarian norms simply evolve along with intra-group norms of cooperation as part of the overall objective of creating an environment conducive to the pursuit of subjective well-being. And note in this context, that the "external enemy" may be the state or some part of the state (e.g., a regulatory agency enforcing rules that the members of the community do not agree with).

When the state attempts to impose its own positive-law rules and they conflict with customary norms, the norms often trump positive law. As Nee (1998: 88) explains, "opposition norms" inevitably evolve as the incentives created by formal institutions and sanctions are weak relative to the incentives to pursue conflicting interests. An accepted "norm" of behavior for many people subject to rules imposed from the top down may be that "breaking the coercively-imposed rule is OK if you can get away with it." For instance, a norm supporting tax evasion and avoidance may be widely adopted. For example, as European governments attempted to establish control over maritime trade in order to tax it, and granted franchises for numerous trading monopolies between 1500 and 1800, 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). Furthermore, the middle and even the upper classes willingly wore, drank, and ate smuggled goods (Rosenberg and Birdzell 1986: 93). Smith (1776: 898) describes the norms implied by such illegal trade, beginning with a characterization of the typical smuggler as

> a person who, though no doubt highly blameable for violating the laws of his country, is frequently incapable of violating those of natural justice, and would have been, in every respect an excellent citizen, had not the laws of his country made that a crime which nature never meant to be so. In those corrupted governments where there is at least a general suspicion of much unnecessary expense, and great misapplication of the public revenue, the laws which guard it are little respected. Not many people are scrupulous about smuggling, when, without perjury, they can find any easy and safe opportunity of doing so. To pretend to have any scruple about buying smuggled goods, though a manifest encouragement to the violation of the revenue laws, and to the perjury which almost always attends it, would in most countries be regarded as one of these pedantic pieces of hypocrisy which, instead of gaining credit with any body, serves only to expose the person who affects to practice them, to the suspicion of being a greater knave than most of his neighbours. By this indulgence of the public, the smuggler is often encouraged to continue a trade which he is thus taught to consider as in some measure innocent; and when the severity of the revenue laws is ready to fall upon him, he is frequently disposed to defend with violence, what he has been accustomed to regard as just property.

Indeed, many smugglers were highly respected members of their communities (e.g., John Hancock). Many other examples of voluntary "illegal" activity could be cited, of course,

ranging from squatter communities in Peru (de Soto 1989) to large scale markets in illicit drugs (Rasmussen and Benson 1994).

The methods of changing customary norms discussed above can also be employed within a customary law community to "change" (i.e., nullify) positive law rules when the community is capable of "enforcing" the alternative norm. In a close knit community, for instance, individuals can agree not to follow the state-made law, and if someone does so, he can face ostracism by the community. Any dispute that arises due to conflict between customary and authoritarian rules can be resolved by the community ADR process, thus avoiding the public courts. Bernstein's (1992) study of "Extralegal Contractual Relations in the Diamond Industry" provides an excellent example, for instance. Indeed, the primary title of her article is "Opting Out of the Legal System." Other examples are discussed below.

Polycentric governance. Inter-group competition does not have to involve conflict. Individuals from different communities may want to voluntarily interact, for instance, but only on some dimensions, so they may want to maintain different sets of rules for different dimensions of interaction. Some individual members of each group must recognize the potential benefits of inter-group interaction and be willing to bear the cost of initiating institutional innovations. After all, such interaction faces a credibility problem. Individuals must feel confident that someone from the other group will not be able to renege on a promise and then escape to the protection of that other group. Because repeated game and reputation affects are localized within each group, and there is limited potential for a boycott sanction, some sort of inter-group insurance or bonding arrangement becomes desirable, along with an apparatus for inter-group dispute resolution. For instance, as inter-group interaction develops the mutual support group can become a surety group as well (Friedman 1979, Solvason 1992, 1993). Membership in a group then serves as a signal of reputable behavior, and if a member of a group cannot or will not pay off a debt to someone from the other group, the debtor's group will. The individual then owes his own group members so the boycott threat comes into play once again.

Under these circumstances, parallel "localized" mutual support groups may be maintained while a "second order of clustering" (Vanberg and Buchanan 1990: 189) is established, facilitating a relatively limited scope for interaction. If people wish to simultaneously facilitate inter-group interaction and impose rules within their community that differ substantially from norm in other groups, they have strong incentives to inform outsiders of the differences in order to avoid conflict and minimize the cost of maintaining non-standard rules. Disputes may still arise, of course, so part of the reciprocal agreements with other groups may be the explicit recognition of differences in laws and procedures for treating conflicts. This in turn implies that as inter-group interactions expand, a hierarchical jurisdictional arrangement may become necessary. For example, each localized group may have jurisdiction over rules for and disputes between its members. Rules for inter-group interactions can differ from both groups' internal rules, although they certainly do not have to, and disputes between members of a confederation of different groups are settled by some "higher" confederation level adjudication process [e.g., see Pospisil (1971)]. Note that these are not "higher courts" where disputes can be appealed from within-group dispute resolution mechanisms (e.g., they are not a supreme authority). Rather, this is a jurisdictional hierarchy defining the role of each adjudication process and allowing for increasingly more distant interactions [as in Pospisil (1971)]. This allows for differences between the rules applied within groups and between groups (Pospisil 1971); a monopoly in "law" is not required. A judgement involving an inter-group dispute will have to be considered to be a fair one by members of both groups, of course. Thus, an equal number of individuals from each group might serve as an arbitration board [e.g., see Benson (1991a)], or a mutually acceptable third party (i.e., an arbitrator or

mediator with a reputation for good judgement) may be chosen [e.g., see Pospisil (1971) and Benson (1989)].

Limits to the extent of an inter-group network of cooperation are determined by the relative costs and benefits of information about other groups. The costs of establishing inter-group cooperative arrangement depend in part on how "distant" the groups are from one another, where distance can be in terms of geographic space, or in terms of the behavioral norms that are relevant to the groups. Thus, extensive interaction between starkly different groups may not arise. These limits are stretched, however, as individuals become members of several groups. After all, as Mises (1957: 257) explains, "Man is not the member of one group only and does not appear on the scene of human affairs solely in the role of a member of one definite group. . . . The conflict of groups is not a conflict between neatly integrated herds of men. It is a conflict between various concerns in the minds of individuals." Thus, the relatively limited jurisdictions of some customary communities are not as constraining as they might appear to be. A person may simultaneously belong to many groups that have well established customs (and be subjects to the commands of several rule-making authorities, e.g., as in a formal federalist system of government), so being in one community does not preclude dealing with people in other communities. A person may belong to a trade association, a homeowners association, a religious group, a fraternal organization, and so on, for instance, each with its own rules and governance institutions. The membership of all of these communities can differ, although considerable overlap may also occur, so individuals may deal with other individuals on some dimensions but not on all dimensions. Indeed, in any complex society, there are many distinguishable systems of rules and institutions, and yet people from many of these different systems interact regularly without having to call upon any institutions of authoritarian law. Thus, inter-group cooperation appears to be the norm rather than the exception, and it appears to be quite widespread. And with good reason: as Gluckman (1955: 20) suggests, "multiple membership of diverse groups and in diverse relationships is . . . the basis of internal cohesion in any society."[15] If an all-inclusive legal system could actually prevent the development and application of customary and contractual norms, it would eliminate the benefits of competition and emulation and undermine the incentives for innovation, as Berman (1983: 10) explains: "The pluralism of . . . law [including customary law], . . . has been, or once was, a source of development, or growth—legal growth as well as political and economic growth. It also has been, or once was, a source of freedom."[16]

The competitive/cooperative relationship between consensual customary legal systems is driven by the desire to facilitate voluntary mutually-beneficial interactions rather than a desire for legal sovereignty. Thus, many different customary systems can co-exist and interact. An understanding of customary law requires that individuals and their organizations be the points

[15] This might sound like a very complex and confusing system for an individual, but recognize that the set of rules that a community develops only applies to those kinds of interactions that are relevant to the community function. Therefore, each community's rules are likely to be quite simple, since their purpose is to facilitate the voluntary interactions of community members and protect those members from harm. One community's rules may be quite different from another community's rules but that does not mean that the two sets of rules are in conflict, as they can arise in the context of vary different kinds of interactions. In contrast, a nation state that attempts to monopolize all law will have to have a very large and complex set of rules, and these rules often can have conflicting purposes (Benson 1999a).

[16] Berman's "or once was" phrase recognizes that diverse legal systems are increasingly being subjugated by authoritarian legal systems. Indeed, while consensual legal arrangements tend to be characterized by internal stability, they face a significant external threat to stability. The size of consensual groups and second order clusters are constrained by transactions costs, and in many cases such organizations have been unable to resist takeover by groups cooperating in the production of violence. This issue is explored below.

of reference rather than "society" as a whole: "there may then be found utterly and radically different bodies of "law" prevailing among these small units, and generalization concerning what happens in 'the' family or in 'this type of association' made on the society's level will have its dangers. The total picture of law-stuff in any society includes along with the Great Law-stuff of the Whole, the sublaw-stuff or bylaw-stuff of the lesser working units" (Llewellyn and Hoebel 1961: 28).

Customary law can be geographically extensive and functionally decentralized (i.e., specialized), in contrast to the law of geographically defined states which tends to be functionally extensive and geographically constrained. Thus, customary law can have different sized jurisdictions for different functions. For some issues, economies of scope or scale may be considerably more limited than any state, for instance, so existing political entities are too large geographically or functionally [e.g., many aspects of domestic commerce may be most effectively governed by diverse trade associations rather than by the state (Benson 1995, Bernstein 1992)]. In other areas of law, such as international commerce, some of these economies appear to be greater in geographic scope than any existing nation can encompass, although many also are narrow in functional scope, as international trade associations may be the most efficient source of rules and governance for many groups of traders.

The polycentric nature of customary law has important implications for the issue of contractual nullification of state-made laws. For instance, nullification need not be complete or universal. A particular authoritarian rule may be very undesirable if it applies to one community, but it may have little or no consequence for another group. In fact, the authoritarian rule may be quite consistent with the customary rule of some community since a substantial portion of the codified law and precedent in many countries is simply a formalization of some politically influential community's customary norms (Benson 1989, 1994). In addition, some communities bring strong ostracism threats to bear, so if a member chooses to call upon the state to enforce a rule that differs from the community's chosen norm, that individual will be boycotted in the future. Other groups may not have sufficiently strong internal commitments to credibly threaten ostracism when a member uses the state to enforce a rule. The first group may nullify while the second does not. So the application of authoritarian rules may differ across groups, just as customary rules can differ from community-to-community.

3. Private trust and recourse in United States history[17]

As Europeans began moving into North America kinship, religious beliefs, ethnic cultural norms, and/or close knit geographic communities frequently provided the basis for cooperation among immigrants to the American continent. Similarly, groups joined together to establish their own rules and trust or recourse mechanisms as a consequence of reciprocal economic interests. This occurred both within merchant communities in the original states and within "frontier" associations that moved west. Several examples of non-state backed contractual arrangement in American history are detailed in light of the preceding presentation to provide a view of the general character of these arrangements.

Religious communities. Some who came to America in the seventeenth century were fleeing religious oppression by the English government. Thus, they broke all the ties with that government that they possibly could, by purposefully moving outside that government's

[17] Parts of this section draw from Benson (1991a, 1995).

reach. Religion's moral teaching provided their rules and the church arbitrated or mediated their disputes.[18]

One example of such a religion-based system of rules was in the Puritan communities. They generally chose mediation when disputes arose. In this regard the role of the church was paramount. Religious offenses like defilement of the Sabbath or heresy were obvious concerns of churches, "but churches also resolved a variety of commercial and property disputes. These included questions of business ethics . . . ; land title disagreements; and, as late as the beginning of the nineteenth century, allegations of breach of contract and fraud" (Auerbach, 1983: 23). Judicial procedure was standardized. The entire congregation typically participated in the dispute resolution process. Individual members actively provided information, opinion, and admonition in mediation procedures. This encouraged a collective congregational judgement, isolating offenders, and thereby strengthening the social order.[19]

These congregations employed a very effective threat of ostracism to induce compliance with their laws. "The sanctions of admonition and excommunication were sufficient for this purpose. The church could neither arrest a wrongdoer nor seize his property, but the danger of expulsion, where church and community were virtually co-extensive loomed ominously" (Auerbach, 1983: 24). Indeed, these communities would not accept into their midst someone who was not, in a sense, "bonded" by church affiliation. And importantly, the rules that these communities adopted were, on many dimensions, different from the rules mandated by English authority, as well as being different from the rules that were relevant in other colonial communities.

Another of the religion-based cooperative communities of the colonial period was the Quakers. Quakers, were not only Christians, of course, but Quaker rules required pacifism, so keeping the peace was a predominant religious concern. In this regard, if a dispute arose

> the complainant, "calmly and friendly," spoke to the other party, trying "by gentle means, in a brotherly and loving manner to obtain his rights." If he was unsuccessful, he reasserted his claim in the company of one or two other "discreet, judicious friends," who were expected to act "justly and expeditiously" to resolve all differences. That failing, they were to "admonish and persuade" the parties to accept arbitration by disinterested Quakers. Refusal to arbitrate diverted the dispute to the monthly meeting. . . . The meeting appointed arbitrators; refusal to abide by their judgement was an intolerable affront to the entire community. . . . The penalty was disownment by the society (Auerbach, 1983: 30).

Clearly the procedures developed by the Quakers were designed to avoid confrontations that might lead to violence and disruption of the society's peace.

Quaker rules and enforcement reached well beyond religious matters despite being enforced through religious institutions. The Quakers also arbitrated business disputes, for example, and the Quaker economic system was very much in the "capitalist" mold, based on private property and free enterprise, as opposed to the mercantilist law of England at the time.

[18] Religion based rules can have a substantial authoritarian component (i.e., cannon law) in as much as a central authority can mandate rules of behavior which are not unanimously accepted. That certainly could have applied in some of the colonial religious communities if the leadership of the group was in a position to propagate its own rules. However, it must be emphasized that virtually all of the individuals in the earliest colonial religious communities chose to join the group and flee Europe because of the strength of their religious beliefs and threat of authoritarian constraints on their religious activities in Europe. Thus, in as much as the members of these groups chose to leave Europe and settle together, they were voluntarily agreeing to the legal/religious system that they established.

[19] This clearly suggesting that rules were not mandated by a centralized leadership group with some authority, as suggested in note 18, but rather, that its primary source of recognition was general agreement among the community as a whole.

Another religious community was established after the United States had split from Great Britain. The Mormons fused politics, religion, and ideology with recognition of private property rights in a fashion that allowed them to virtually establish an independent, territorially autonomous society in Utah ruled through the church. Mormon judicial procedure was hierarchical in a fashion somewhat reminiscent of the Quakers. Church members were appointed by the High Council president to serve as "home teachers." They made monthly visits to all church members in order to, first of all (Auerbach, 1983: 56),

> ferret out inequity and sin, but secondly to arbitrate disagreements. If home teachers were not successful in resolving a dispute, it went before a bishop's court. This court had jurisdiction over both religious and what would now be considered criminal infractions—everything from blasphemy to cattle theft and water diversion. Failure to reach an agreement at this level meant that the dispute went to the High Council where the president and two counsellors, with the aid and advice of up to twelve high priests, decided the issue. Refusal to comply led to disfellowship and excommunication, the ultimate sanctions, [which] enclosed the community once again by removing its deviant members.

This Mormon system is widely recognized as having established rules in direct violation of United States law (e.g., polygamy).[20]

Ethnic immigrant communities. Chinese in urban Chinatowns, Scandinavians in Minnesota and North Dakota, as well as Eastern Europeans and Jewish emigrants to Eastern American cities all established their own systems of rules and mechanisms for trust and/or recourse outside the federal, state, or local government which supposedly ruled over the geographic territories that encompassed their communities. While commonality of religious beliefs was at times present, more important sources of cohesion appears to have been kinship, ethnic cultural norms, and economic relationships. For instance, "American Chinatowns were conspicuously insular" (Auerbach, 1983: 74). The Chinese, in fact, had little choice but to produce their own rules and mechanisms to back them. The California Supreme court held, during the 1850s, that Chinese were "a race of people whom nature has marked as inferior," for example, and therefore ruled that their testimony against whites was inadmissible (Auerbach, 1983: 74). The fact is that government law was used as an unjust discriminatory tool against Chinese so they had to produce their own justice.

Law in China was largely kinship-based custom at the time of the large nineteenth century migrations. Consequently, a similar system to those existing in Chinese villages was exercised through the local benevolent associations in American Chinatowns. Merchant elders took on the role as mediators for communities consisting of numerous clans and local

[20] As explained below, government in the United States has often attempted to suppress or undermine alternative systems of rules that conflict with those mandated by government, In this context, note that the Mormon system remained independent from the United States government into the last half of the nineteenth century when it finally was forced to submit (Auerbach, 1983: 6):

> By the second half of the nineteenth century the United States government, strengthened by the nationalistic fervor of the Civil War, had limited tolerance for flagrant challenges to dominant culture and legal mores and for resistance to the reach of federal authority. As the weapons of war had forcibly returned the Confederacy to the Union, so the weapons of [authoritarian] law (backed by the threat of force) tamed the Mormons. The price of peace was conformity; only when the Mormons repudiated polygamy and accepted substantial divestiture of church property did the government relent. With Mormonism reduced to a religion in a secular society . . . , church sanctions lost their expansive effectiveness.

Within less than one hundred years of the country's formation by individuals espousing religious freedom and individual liberty, its authoritarian legal apparatus was suppressing both. Indeed, the revolution against the power of the British Monarchy was in no small part, a result of precisely the same use of authoritarian power, since many of the founding fathers were themselves people or descendants of people who moved to America to achieve religious freedom.

associations. Each such group took care of internal conflicts while a Consolidated Benevolent Association provided mediation of disputes between members of different groups. "Ostracism, mixed with shame of public scrutiny (and no doubt an occasional threat), was a strong deterrent" (Auerbach, 1983: 75). The community based system of rules and internal conflict resolution did not begin to yield to state law enforcement until after World War II.

"Among the various immigrant groups for whom internal dispute-settlement procedure were vital for community cohesion, none migrated with as strong a historical commitment to law, and as deep a mistrust of alien legal systems, as the Jews of Europe. Jews were a people whose religion was law; they clung to the Torah to preserve their identity as a people during two millennia in dispersion. . . . In the most literal respects the Torah was their living law" (Auerbach, 1983: 76). Throughout Europe, Jews maintained strong desires for religious, cultural and economic autonomy. Thus, with vary degrees of success over time and across countries, they enforced their own rules through their synagogues and the Batei Din or rabbinical courts (Goldstein, 1981: 3–68). The Batei Din arbitrated virtually every kind of disputes among European Jews.

Throughout much of the colonial period individuals in the relatively small Jewish American community called upon the Jewish court in London to arbitrate disputes (Goldstein, 1981: 69). Jewish courts were established in various American cities during the first half of the nineteenth century but apparently they were not very active, as Jewish communities remained small and probably relied on trust mechanisms and mediation to maintain their rules, rather than recourse. As the Jewish population expanded in the last half of the century, however, several Batei Din were established by Rabbis of large congregations and functioned as they had in Europe (Goldstein, 1981: 70–71). In the early part of the twentieth century, New York Jewry explicitly revived the European institution of Kehillah (community) in an effort to facilitate economic and cultural interaction. Rabbis did not have widespread following in America so they could not serve the strong adjudicative role they had historically. However, their European experience led the Jewish Kehillah to establish a dispute resolution system, beginning with a Bureau of Industry around 1910, to mediate and bring a degree of order to the clothing, fur and millinery industries. Their success in industrial mediation led them, by 1914, to develop a court of arbitration and network of neighborhood arbitration boards to handle the full range of commercial and religious disputes (Auerbach, 1983: 80). This system was dominant in the provision of rules and order to the Lower East Side Jewish community until after World War I, and the principles established by the Kehillah persisted for some time beyond that.

The post-war period saw the New York Jewish community develop a variety of arbitration tribunals. The same occurred in other cities as well. Again the procedures were informal and disputes were resolved according to Jewish and Yiddish customary law. One important arbitration tribunal in New York—the Jewish Arbitration Court—resolved thousands of disputes during the 1920's and had branch offices throughout the New York Jewish community. It was funded and staffed through philanthropic and professional support. This private court actually faced stiff competition in the market for disputes from the Jewish Conciliation Court of America (Auerbach, 1983: 86), which, since 1930, has played an increasingly important role in the New York Jewish community (Goldstein, 1981: 72). In some cities, however, as the Jewish Community was assimilated into American society, their arbitration courts gradually took on characteristics of the public courts (or the American Arbitration Associations' procedures, as suggested below) and some lost their ability to attract constituents. Nonetheless, Batei Din and Jewish courts of arbitration have continued to function in the United States (Goldstein, 1981: 71).

Contracting to establish property rights. Individuals began moving into the Western lands that were "owned" by the United States government long before the government surveyed this "public domain" or made it "available" for sale or settlement. These "squatters" had no claim to the land according to federal law, but they claimed it anyway. Naturally, disputes over the possession and use of the land or its product could not be settled under state law even if its courts had been available, because state law was in conflict with the community's rules. "The result was the formation of 'extra-legal' organizations for protection and justice. These land clubs or claim associations . . . were found throughout the Middle West" (Anderson and Hill, 1979: 15).

The land clubs and claim associations each adopted their own written contract setting out the rules which provided the means for defining and protecting property rights in land. They established procedures for registration of land claims, as well as for protection of those claims and adjudication of internal disputes that arose. Anderson and Hill (1979) did not discuss how these organizations could have successfully generated compliance with their rules and judgments, but by now the method should be obvious. The reciprocal arrangements for protection would be maintained only if a member complied with the association's rules and its court's rulings. Anyone who refused would be ostracized. Boycott by a land club meant that an individual had no protection from aggression other than what he could provide himself.

Similarly, gold was discovered in California in 1848, attracting hundreds of thousands of people to the area within a very short period of time. Umbeck (1981: 67) explains that, "At the territorial and federal level there was no legal institutions restraining the behavior of miners . . . even if there had been such institutions, they could not have been enforced. By the end of 1848, or the beginning of 1849, the miners began forming contracts with one another to restrain their own behavior."[21] While there was some representation of federal authority in California, in the form of military posts, their primary function was apparently to take care of Indian troubles and they did not exercise any authority over the mining camps. Moreover, prior to 1852 the State government did not even enforce laws against murder and robbery, let alone laws regarding mining claims. But if they had, they clearly would have been enforcing a very different set of laws than the rules governing the mining camps.

The earliest contractual arrangements that developed (primarily before 1850) involved small groups of miners. The only contractually controlled activities related to gold mining, and the agreement typically involved equal shares of all gold found. Generally, agreements among larger groups were not needed since gold deposits were so widespread and relatively few miners were in the area. Therefore, there were no significant disputes over claims. This was not to last. The Harbor Master's Office in San Francisco reported the arrival of almost 40,000 people from throughout the world in 1849; the population of California was estimated at 107,000 by the end of 1849 and reached 264,000 by the end of 1852 (Umbeck, 1981: 89).

As the size of the mining population grew and the mineral lands became relatively more scarce, contractual arrangements began to change. Rather than sharing the gold from a joint production effort, each individual was given the exclusive rights to a specific piece of land, and "Ownership of the gold went with the land" (Umbeck, 1981; 90). These property rights were assigned and enforced by the miners themselves. The first step in this process of

[21] Very similar situations also arose later in Colorado, Montana and Idaho, where "in each case, the first to arrive were forced into a situation where they had to write the rules of the game" (Anderson and Hill, 1979: 18).

contracting was a "miners' meeting" for the purpose of setting up a "mining district." Such meetings were apparently organized when the need arose—that is, when minable land became scarce enough to create the potential for disputes and violent confrontations. The rules set by miners' meetings were always chosen by majority rule, but individuals who did not agree with the majority were not forced to accept its rules. They were free to opt out of the contract for reciprocal protection of rights. If a minority disagreed with a majority they could set up their own separate district with different rules. Thus, those governed by a particular set of rules actually unanimously agreed to be so governed (Anderson and Hill, 1979: 19).

One result of these meetings was specification of the geographic boundary of the mining district—the area over which the laws of the group would apply—and the size of the piece of land each miner could claim within that area. Claims were allocated on a first come first serve basis. In order to retain rights to a claim a miner was required to work it a specified number of days out of each week. Then, as long as a miner complied with these rules, the entire community of miners were obliged to defend his rights under the privately contracted set of rules of the district. "If the miner failed to comply with the terms of the contract, his claim was considered by others to be nonexclusive and open to any jumpers" (Umbeck, 1981: 93). Thus, the reciprocal arrangements for protection where backed by ostracism.

Rights to mineral lands were not the only laws in the mining camps. Canlis (1961: 2), in his examination of the evolution of law enforcement in California, found that miners possessed a strong desire for order. Consequently, they established and enforced a full range of private property rights.

Umbeck (1981: 114) pointed out that miners generally could hire an enforcement specialist or they could enforce their rules through group action. Some camps appointed or elected an *alcalde* or justice of the peace to act as an arbitrator in mining disputes. In such cases, given that decisions were acceptable to the majority of miners, the arbitrator was backed by the community at large. When the majority disagreed, a new alcalde was appointed. Most districts did not elect any arbitrator, however. More typically, when a dispute arose each party appointed a representative and these two picked a third. Then the three would arbitrate the dispute. The decision was affected if acceptable to the other miners in the district. Another alternative for dispute resolution was a "miners' court." By this method, a subset of the miners in the district would be summoned when a dispute arose. A presiding officer or judge was then elected and a jury was selected. The rulings of the arbitrators or miners' court were rarely disputed, but if one was, a mass meeting of the camp could be called where a dissatisfied party could plead his case and possibly get the decision reversed (Anderson and Hill, 1979: 20).

Reid (1980: 3–4) notes, "Apparently one need only state the proposition that America's mining frontier was lawless to prove the fact . . . [but] Contemporaries who experienced that 'rampant' lawlessness in California would have been amazed by the descriptions written during the twentieth century about their society. They thought it was more law abiding than lawless." The fact is that there were very few robberies, thefts, or murders in the camps (Reid, 1980: 5; Canlis, 1961). Property rights apparently were very secure (Canlis, 1961).[22] Violent crimes occasionally occurred and if sufficient illegal activity arose miners would arm themselves for protection. Even so, the violence was minimal. The contractual systems

[22] As further evidence, consider the obvious confidence that miners had in their privately produced and

of rules effectively generated cooperation rather than conflict, and on those occasions when conflict arose it was, by-in-large, effectively quelled.[23]

Commercial organizations. Some of the strongest evidence of efforts to contract around state-made commercial law in the U.S. can be illustrated by an examination of the use of arbitration rather than public courts. Prior to the passage of statutes by New York (1920), New Jersey (1923), the federal government (1925), Oregon (1925), Massachusetts (1925), Pennsylvania (1927) and California (1927), commanding their common law courts to enforce arbitration agreements and rulings, agreements to arbitrate were generally not considered binding under U.S. common law, and at least for a portion of U.S. history prior to the 1920s, hostile judges felt free to overturn arbitration decisions if one of the parties chose to litigate.[24] Nonetheless, an examination of newspapers, merchant letters, and the records of organizations providing arbitration services clearly demonstrate that commercial arbitration actually was in widespread use in each of the original Colonies almost three centuries before modern arbitration statutes were passed, and that after the revolution, arbitration remained in wide use in the all of the states.[25] The use of commercial arbitration developed during the colonial and post-revolutionary periods in spite of judicial hostility. Later in the nineteenth century, a trend toward less hostility can be detected in several state courts (MacNeil 1992; Benson 1995, 1998c), but the use of arbitration continued to expand both in states where the courts were relatively receptive and states where they were not (Benson 1995, 1998c).

protected property rights system. Umbeck (1981, pp. 96–97) listed several pieces of historical evidence of this confidence:

1. From 1849 to 1866 scarce resources were used by miners to agree upon and to enforce the contractual provisions. Any individual found guilty of a violation was punished immediately. [If the miners did not have faith in the system why would they devote time, effort and resources to promote it?]
2. By 1849 and throughout the 1850s and 1860s, it was observed that miners were devoting hundreds of thousands of dollars in developing their claims... In other words, the miners behaved as if they had some expectation of continued use rights.
3. By 1850 most districts allowed miners to buy and sell claims and shortly thereafter this transfer of mining rights became a common occurrence. Some of the richer claims were exchanged for thousands of dollars. Had exclusive rights to the claim not existed, no one would have paid for them.
4. In 1866 the federal government passed an act allowing miners to acquire fee simple absolute in mineral lands. By 1867 only 4 claims had been patented and in 1869 and 1870 a total of 6 claims had been patented. This does not prove that miners already had property rights, but it does indicate that the additional benefits of federally recognized rights were not worth the patenting cost for most miners.
5. The mining act of 1866 legally recognized the rights of miners to the exclusive use of what was previously public land. Yet with this federal recognition and enforcement of property rights, there was no noticeable change in total gold yield...
6. In his report of 1868, government agent J. Ross Browne gives a detailed report on the history and current operations of hundreds of mines in California. I can detect no systematic change in resource allocation after 1866.

When property rights are not clearly assigned, resources tend to be used up more quickly than when clearly delineated private rights exist. Since no distinguishable change in the use of California's mineral lands occurred following governmental recognition of private rights to that land, we can assume that those rights actually existed prior to the government's action.

[23] The relatively peaceful character of mining camps actually appears to apply to most of the frontier communities of the American West (Anderson and Hill 1979, 2004, McGrath 1984, Benson 1991a, 1998d).

[24] See Benson (1995) for references to cases and literature discussing this topic.

[25] See Benson (1995) for historical references.

For instance, as New York merchants organized into various associations and exchanges, provisions were always made for the arbitration of disputes among members (Jones 1956: 214), despite New York's maintenance of the doctrine of revocability until 1920.

The volume of evidence regarding the widespread and growing use of arbitration is particularly heavy for the last four decades of the nineteenth century (Jones 1956: 214–215; Wooldridge 1970: 101; Auerbach 1983; MacNeil 1992; Benson 1995, 1998c). Indeed, these developments suggest that arbitration was being substituted for litigation for both procedural reasons [rising litigation costs due to court congestion and trial delay (Benson 1995, 1998c)] and jurisdictional reasons (i.e., an effort to avoid the application or effect of state-made rules) reflecting increasing uncertainty 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). Incentives to establish contractual arrangements and organizations (e.g., trade associations, commercial exchanges) to govern the process of dispute resolution and insure against litigation (e.g., arbitration clauses, arbitration institutions, institutionalized private sanctions) through public courts that would apply statute or precedent law rather than business custom (practice and usage) were clearly increasing, so that by the end of World War I, arbitration had made the courts irrelevant for contract disputes in large segments of the business community in the United States (Wooldridge 1970: 101).

Still, states began passing arbitration statutes in the 1920s, mandating that the courts back arbitration rulings. Why? The primary political impetus behind arbitration statutes came from Bar Associations (Auerbach 1983) as lawyers saw the growing use of arbitration without lawyers as a threat to their control over contract writing and dispute resolution (Benson 1995, 1998c). Indeed, arbitration, as it was developing, not only avoided the use of lawyers, but it was hostile toward the legal profession. The feelings that many trade associations had regarding lawyer involvement in their arbitration processes is suggested by an officer of the Silk Association who argued that businessmen can settle their disputes better than lawyers because a lawyer "is going to dominate the situation and bind the thing up with technicalities and precedents" rather than yield to business expertise and an "ordinary understanding of what is right and what is wrong" (Auerbach 1983: 108).

While many lawyers may have preferred to squelch the competitive threat posed by arbitration, others apparently realized that its rapid development and widespread use made its elimination impossible.[26] If an alternative forum to the public courts was to be used, however, trial lawyers wanted that forum to be one that they might be able to influence and perhaps even dominate. An obvious hypothesis follows: lawyers hoped to initiate arbitration statutes written in a way that would lead to a role for lawyers in the arbitration process, and they sought such statutes by lobbying through their Bar Associations. This hypothesis might be questioned because many and perhaps most lawyers in Bar Associations are probably never involved in litigation. This does not mean that arbitration did not pose at least some indirect threat to many of them, however. For instance, carefully drafted contracts and dispute resolution procedures are substitutable, at least to a degree. Trade associations demonstrated considerable animosity toward lawyers in general, and the availability of their internal

[26] Many lawyers clearly recognized that they would benefit if the incentives to use arbitration were somehow reduced, so that commercial disputes could be shifted back to the public courts. The 1919 meeting of the New York Bar Association involved a vigorous debate over general arbitration clauses, for instance, with many lawyers arguing that such clauses should be illegal, supposedly because they required businessmen to sign away their right to a fair trial. The real fear, that arbitration clauses significantly reduced lawyers' business, was explicitly stated by many Association members, however, and "echoed throughout the arbitration debate" (Auerbach 1983: 105–106).

arbitration arrangements may have allowed association members to avoid some expenses for contract-drafting lawyers as well as for trial lawyers. Privately arbitrated contracts, particularly within narrowly focused commercial organizations, require less formality in contracting because the parties are intimately familiar with business practice and custom in their particular area of transactions; they understand what a general statement in a contract means, *and* they can choose an arbitrator with similar intimate understanding. However, a judge is much less likely to have such an understanding, so a contract that may face judicial scrutiny will have to be much more specific and formal in order to avoid a high probability of judicial error (Charny 1990: 385, 404). Thus, the growth of arbitration was probably a threat to contract writing lawyers as well as trial lawyers.

As suggested above and discussed in more detail below, state actions can undermine the ability to use contracts as a means of avoiding state made law. Cohen (1921: 150) observed, shortly after the New York Arbitration Act's passage in 1920, that this statute "establishes legal machinery for protecting, safeguarding and supervising commercial arbitration. Instead of narrowing the jurisdiction of the Supreme Court it broadens it. . . . Instead of being ousted of jurisdiction over arbitration, the courts are given jurisdiction over them, and . . . the party aggrieved has his ready recourse to the courts" (emphasis added). Prior to the statute's passage, credibility for arbitration agreements in New York came from private sanctions, often imposed by formal and informal business groups. The statute essentially asserted that the state was the source of authority and sanctions for such agreements. As explained below, many lawyers became active in arbitration because of these statutes, just as they presumably intended when they advocated their passage, because some businessmen became more concerned about potential appeals. The result appears to have been a self-fulfilling prophecy, because as lawyers became involved, an enormous number of court cases were filed to determine what characteristics of arbitration would be considered "legal" by the public courts [see Sturges (1930)]. Cases involved such issues as the appropriate way to select arbitrators, whether lawyers had to be present, whether stenographic notes of the proceedings should be taken, and so on. As similar statutes were passed elsewhere arbitration litigation mounted. Cases over jurisdictional issues involved courts from and appeals in multiple states (Auerbach 1983: 110). Lawyers maintained that businesses, forced to pay attention to the prospect of judicial review, had to make their arbitration processes compatible with statute and precedent law including public court procedure.

A Harvard business law professor who observed the period immediately following passage of the 1920s statutes, wrote "There is irony in the fate of one who takes precautions to avoid litigation by submitting to arbitration, and who, as a reward for his pain, finds himself in court fighting not on the merits of his case but on the merits of arbitration . . . [This] monumental tragicomedy . . . [demonstrates the success of the state's legal system at] thwarting legitimate efforts to escape its tortuous procedure" (Isaacs 1930: 149–151). Litigation over arbitrated rulings has continued, and the early 1980s were still witnessing a "growing number of court challenges to arbitration awards" (Ashe 1983: 42). This appears to reflect that fact that the statutes and the increasing complexity of precedent law forced some businesses to involve lawyers in their contracting and arbitration in an effort to insure that the arbitration process itself will stand up to judicial scrutiny, and this in turn has created a principal-agent problem. Lawyers are in a position to extract rents by influencing some business' decisions regarding dispute resolution, so Ashe (1983: 42) concludes that the increase in appeals reflects the increasing use of lawyers in arbitration: losing attorneys have a stronger tendency to circumvent the arbitrator's decision than there is for the losing party who, in the absence of legal "advice," would tend to have greater "allegiance to the system of arbitration itself." The growing level of litigation of arbitration rulings is certainly correlated

with the increasing involvement of lawyers in the process (Ashe 1983: 42), supporting this hypothesis.[27]

It appears that modern arbitration statutes have significantly increased the cost of arbitration and reduced its attractiveness (Auerbach 1983; Ashe 1983).[28] Indeed, arbitration is less expensive than litigation only if "parties do not take advantage of certain states' statutes allowing them to resort to court prior to arbitration or to demand review of the arbitrators' award through appeal" (Lazarus, et al. 1965: 106; also see Charny 1990: 427). The incentives to insert arbitration clauses into contracts appear to be undermined, at least to a degree. In fact, however, how widespread and important these increased transaction costs might be is actually difficult to determine, although the U.S. experience provides some insights.

In this context, there really is no "business community." There are many business communities, but for illustrative purposes these communities can be classified into three categories in order to consider the consequences of legal sanctions backing arbitration. First, a large portion of the business communities apparently can enforce contracts without legal sanctions and use private sanctions to induce their members not to use lawyers or appeal arbitration rulings to common law courts. Trade associations and exchanges have already organized a natural reciprocal support arrangement, so it has been relatively easy for them to establish their own specialized arbitration systems, information transmission mechanisms, and/or automatic sanctions that make arbitration promises credible. Thus, the statutes providing legal backing for arbitration probably have had little impact on these businesses. They can still use arbitration as a mechanism for jurisdictional choice (i.e., to nullify state-made laws in order to apply their own preferred rules) as well as for its procedural advantages. Mentschikoff (1961: 857) reports that about 40 percent of the nation's trade associations explicitly prevented attorney representation in arbitration in the 1950s, for instance, while attorney involvement in the other roughly 60 percent was "highly unlikely."

Second, some businesses may not be part of formal contractual associations with established arbitration procedures and effective ostracism mechanisms, but they can still attempt to avoid the slow and costly public courts by using the arbitration specialists provided by lawyer-dominated organizations such as the AAA (e.g., by including standard arbitration

[27] Also see Bernstein (1992: 156) for related discussion about the growing use of lawyers in diamond industry arbitration.

[28] There may be other transaction costs associated with the statutes and resulting involvement of lawyers that reduce arbitration's attractiveness. For instance, Mentschikoff's (1961: 14) seminal research on arbitration using AAA records as well as personal observations, concludes that "in the great majority of cases ... lawyer participation not only failed to facilitate decisions, but ... materially lengthen[ed] and complicate[d] the presentation of the cases." Mentschikoff also finds that lawyers do not understand businesses usage and practices (i.e., customary rules) that typically are relevant to business disputes, and that is one reason for AAA proceedings becoming unduly technical and creating unnecessary delays. Similarly, Lazarus, et al. (1965: 95) conclude, on the basis of an arbitrator questionnaire, that lawyers tend to be less than adequately prepared to represent clients in arbitration hearings, and that they are "reluctant to abandon practices condoned and valued in the courtroom." Essentially, a moral hazard appears to have been created: in part due to the incentives to encourage appeals after arbitration, lawyers may have relatively strong incentives to shirk during arbitration, which they may perceive as a procedural stage of legal dispute resolution rather than an alternative to litigation. Lawyers apparently also have incentives to make arbitration like litigation. Lazarus, et al. (1965: 102) stress that arbitration's "strongest points lie in those areas where it most widely differs from courts," for instance, but note that arbitration proceedings by the AAA have "been altered to accommodate lawyers" making them more like court proceedings as a result. Ashe (1983: 42) similarly argues that with more and more lawyers used in AAA arbitration, "as arbitration becomes more like a court proceeding, the benefit to the participants for whom it was designed diminishes. Such a development is destructive of the process, not only because of the increased time and cost that accompanies it, but because it encourages the process to be viewed by the courts as only one more step in the already lengthy litigation process."

clauses in contracts, or by agreeing to arbitrate after the fact). Indeed, it may well be that for some (many?) of the businesses that turn to such unaffiliated sources of arbitration, a legal sanction is the primary source of credibility backing their commitments to arbitrate. This may in turn means that because private sanctions are relatively weak, appeal is more likely and therefore that there is a strong incentive to involve lawyers in all disputes from the outset, even if they are arbitrated. Such implications do not deny the points made above about the relatively high costs that arise with lawyer involvement, and so on.[29] Indeed, it reinforces the suggestion that there may well be principal-agent and moral hazard problems for those transactors who cannot employ strong private sanctions. Asymmetric information about legal issues means that the lawyers may be in a position to behave opportunistically, even to the point of encouraging relatively more appeals to the courts than might occur in a full-information world, thus explaining the relatively large number of appeals that have occurred under the modern arbitration statutes, as well as the behavior and consequences observed by Mentschikoff, Lazarus, et al., Auerbach, and Ashe. Nonetheless, lawyer involvement in such proceedings may be the low cost alternative given the role that legal sanctions play for those involved in such disputes: these costs are relatively high, only when compared to an unobtainable alternative that characterized many trade associations (unobtainable due to the lack of an effective private sanction). They are relatively low as compared to the real alternative: the expected costs of litigation in public courts.

Under these circumstances, arbitration is probably much less relevant as a mechanism for rule-nullifying jurisdictional choice, however, in part because the level of lawyer involvement will mitigate against application of business practice and custom as lawyers turn to the sources of rules that are more familiar to them. After all, transactors must be more careful and formal in writing their contracts in order to make sure that an uninformed judge will not make a mistake, so lawyers become more important as inputs to contract writing too, reducing the likelihood that business practice and usage will be considered. For the businesses choosing arbitration under these conditions, the choice probably reflects its procedural advantages. Note that this is consistent with the widespread view among U.S. legal scholars who see arbitration as a procedural rather than a jurisdictional choice. AAA arbitration has been the most visible and most studied of all the arbitration arrangements in the U.S., for instance, and if the arguments made here are correct, this source of arbitration is predominantly a procedural option.[30] Importantly, however, the AAA provided only an estimated 27 percent of all commercial arbitration in the 1950s (Mentschikoff 1961: 857). Similarly, Lazarus et al. (1965: 92) surveyed 1,673 trade associations in 1965, and all respondents indicated that none of them encouraged legal representation (lawyers were either forbidden, permitted with

[29] See note 28 in this regard.

[30] Mentschikoff's (1961: 14) conclusion cited in note 28 that lawyers fail to facilitate decisions, and actually materially lengthen and complicate cases arises in the context of her focus on AAA arbitration, for example, and many subsequent writers tend to attribute the characteristics she observed to arbitration in general [for example, see Auerbach (1983), Ashe (1983), and to a degree, Lazarus, et al. (1965), but also see Willoughby (1929: 58) for similar arguments made prior to Mentschikoff's article]. Lawyer participation in AAA arbitration as council rose from 36 percent in 1927 to 70 percent in 1938, 84 percent in 1942, and 91 percent in 1947 (Auerbach 1983: 111; Kellor 1948: 26), and it probably is near 100 percent today. Auerbach (1983), Ashe (1983) and others cited above apparently put too much emphasis on the success lawyers have in influencing the AAA as evidence of a virtually complete "legalization" of commercial arbitration in general, however. Judges and lawyers joined the AAA in strength, they have a significant presence in the AAA as members of the Board of Directors and of various committees, and they have a substantial influence over AAA policies and procedures (Kellor 1948: 18), thus opening "to lawyers a general practice that is lucrative to them" (Kellor 1948: 69). The AAA does not appear to be typical of arbitration from other forums, however, such as those that are internal to trade associations.

limitations, or permitted but "not encouraged"). In contrast, the AAA "openly encourages lawyer participation at all steps of the arbitration procedure, from the drafting of arbitration clauses in contracts to the hearing itself" (Lazarus, et al. 1965: 92), contending that lawyers are essential to the process (AAA 1964: 6–7). Therefore, it is not at all clear that the characteristics of AAA arbitration apply for the majority of commercial arbitration in the United States, let alone internationally.[31] Arbitration within trade associations has rarely been studied, on the other hand, and it is this source of arbitration that is most likely to involve a jurisdictional choice. Bernstein's (1992) study of the diamond traders organization is particularly relevant in this context, and she emphasizes that customary law is applied rather than state law.

Private sanctions can be very powerful outside of formal associations and informal groups, of course, so it also does not follow that all of the disputes taken before third parties such as AAA arbitrators require legal sanctions for backing. That is, a third category of business communities may lie between those with strong and weak private sanctions (indeed, a continuum may be more appropriate than the three discrete groupings suggested here). Private sanctions may be relatively weak in the third catagory compared to the first one discussed above, but still sufficiently strong to induce compliance with arbitration, and therefore with business custom rather than state-made rules, under most circumstances in the absence of legal sanctions. However, with the advent of legal sanctions and the potential for appeal, the transaction costs associated with arbitration rise due to the reasons suggested above. How many businesses are actually worse off because they have been forced to include lawyers and consider the implications of appeal? There is really no way to tell, in part because the statutes themselves may significantly diverted the path of arbitration's evolution. Indeed, and importantly, these various communities should not be considered in a static sense as exogenously determined. As Charny (1990: 428) explains, the existence of legal sanctions may stifle the development of trust relationships from which private sanctioning mechanisms (private recourse) often spring, because the honoring of any commitment may often be perceived to arise primarily because of the deterrent effect of legal sanctions. That is, the incentives to develop private sanctions may be undermined by such statutes and this in turn adds to the size of this third category (and the second) relative to what it would be without the statutes. Thus, it reduces the potential for arbitration to serve as a jurisdictional option.

The costs of using litigation are also high and rising, however, so it appears that the use of arbitration and other forms of ADR are actually continuing to rise as more and more contracts include arbitration clauses. While commercial arbitration between businesses is widely used, as suggested above, arbitration of disputes between businesses and their customers also appears to be increasingly common (and of course, labor arbitration has a long history—see Benson (2000a) for comparisons of commercial and labor arbitration). For instance, the New York Stock Exchange formally provided for arbitration in its 1817 constitution, and it "has been working successfully ever since," primarily to rectify disputes between New York Stock Exchange members and their customers (Lazarus, et al. 1965: 27). The Council of Better Business Bureaus (BBB) operates arbitration programs for consumers in many parts of the country, and they encourage businesses to pre-commit to arbitration with customer. Several automobile manufacturers have contracts with the BBB to arbitrate car owners' complaints. In addition, insurance companies arbitrate many thousands of claims each year (Denenberg and Denenberg 1981: 8, Wooldridge 1970: 101). The National Association of Home Builders has a Home Owners Warranty program that offers arbitration of buyers' complaints against the association's builders and this procedure is employed thousands of

[31] See Bernstein (1992: 156), for instance.

times each year (Denenberg and Denenberg 1981: 5). Medical malpractice arbitration, begun in 1929, is on the rise as malpractice litigation has become more costly and widespread. For example, subscribers to the Kaiser Foundation of health plans of California, the nation's largest prepaid medical care system, agree to arbitrate any claims when they sign up, and arbitration clauses are common in contracts with HMOs. Much of this arbitration may arise due to procedural advantages, but at least some of it also reflects contractual nullification (jurisdictional choice), as explained below.

Variation in the ability to contract around state-made law. The relatively small number of examples of contractual arrangements that have involved at least some nullification of state-made law should not suggest that the phenomena has been or is limited in scope. Auerbach (1983: 16) documents many more, for instance, and still notes that the examples in his book "could easily be multiplied tenfold."

Nonetheless, the potential for contracting around bad rules clearly varies considerably, even in the United States, as just suggested in the discussion of different categories of business disputes depending on the strength of private sanctions. Still, it is relatively easy for many (but not all, as suggested above) business communities to contract around state-made law, as contracting partners can specify their own rules and then designate an arbitration forum to handle their disputes under those rules. As long as the arbitrator focuses on the contract and on trade practice and usage (custom), rather than on state-made law [as they often do (Benson 1998a, 1998b, 1999b, 2000a, Bernstein 1992)], the combination of contracting and arbitration can nullify rules created by the state.

Pre-dispute contracting to nullify state-made law may be less likely to arise when the dispute is over liability in accidents (tort). It certainly is not impossible, however. Mutual insurance arrangements may establish liability rules contractually for members of a close-knit group [e.g., see Solvason's (1992, 1993) discussion of medieval Iceland]. Insurance markets also can provide contractual protection against tort liability involving strangers, and perhaps through negotiation, insurance companies can agree to different rules than those implied by precedent and agree to arbitrate disputes (a substantial number of insurance disputes are arbitrated, as noted above), but in the United States today injured parties can still sue both tortfeasers and the provider of their insurance, so such contracts may not be able to do very much in the way of nullifying potential tort precedents. After-the-accident bargains and contracts are also possible if the rules are "bad" enough, of course, as parties can settle out of court, but both parties must agree to do so since one can be forced into court by the other if the coercive institutions of the state are brought to bear. Thus, settlements may imply that both parties expect to be better off by avoiding litigation costs [including court delay, a substantial cost in many jurisdictions (Neely 1982: 164–165)], or that both parties believe that the relevant state-made rule is a bad one. And in fact, there are examples of attempts to do so. Contracts with many hospitals and Health Maintenance Organizations contain arbitration clauses, for instance, in an effort to move medical malpractice disputes out of the common-law courts. This alternative has not been successful at preventing a great deal of litigation in some jurisdictions, however. After all, when a coercively-backed dispute resolution forum is expected to favor a particular category of litigants by transferring wealth to them, those litigants will not agree to avoid that forum or negate its biased rules unless the personal costs of obtaining such biased results are high (as they could be in a repeated-dealing arrangement or a close-knit community such as a trade association). External costs, such as the reduced level of medical care available in jurisdictions with high medical malpractice-insurance premiums due to large tort awards, are not likely to be relevant to potential plaintiffs. Collective action problems are also significant for consumer groups who might recognize unintended consequences such as reduced availability of some medical

services and rising medical costs, and if doctors or hospitals attempt to boycott a litigious patient, the political fallout would be tremendous. Thus, doctors are more likely to exit (leave one state and move to another, retire early, change specialties to escape one that is particularly vulnerable to tort claims). There is a widespread perception that courts in several states tend to be biased in favor of patients in medical malpractice suits [reasons are similar to those discussed below for changes in product liability tort]. Growing empirical evidence supports the validity of this perception (Benson and Fournier 1998) while also suggesting that there is a trend toward increasing awards to patients in medical-malpractice tort actions. Thus, in the current legal/political environment, medical malpractice tort law is not likely to be avoided through contract and arbitration. Even a contractual stipulation of arbitration is irrelevant if the coercive and biased court does not enforce the contract, or if the arbitration ruling must be "approved" by the court.

Historically, tort law has provided the default rules governing interpersonal disputes when the parties had not specified alternative rules or procedures in advance (e.g., contractual warrantees), thereby providing a mechanism to encouraged individual responsibility by forcing people to pay for the harms they inflicted upon others through intent or negligence. However, tort law has increasingly become a mechanism to provide "social insurance" by imposing liability on the party that the courts believes is the best able to afford it (e.g., a manufacturer) or by spreading the risk of injury across all members of society regardless of fault (e.g., strict liability is expected to force firms to increase their purchase of insurance, and raise their prices to all customers in order to pay for that insurance). Tort law is therefore becoming a mechanism for redistributing wealth rather than a mechanism for compensating for injuries by imposing responsibility on those at fault in non-contractual interactions that generate harm. And furthermore, rather than being a default mechanism when contracting is not possible, "the revolution in the law of tort . . . began and ended with widespread repudiation of contract law" (Rowley 1989: 379).

Consider product liability, which used to be a contract issue under common law. Manufacturers owed a duty of care only to those who contracted directly with them, and damages could be specified by contract (e.g., limited warranties), particularly if harms were likely or if courts made inefficiently large or small damage awards. However, this duty has gradually expanded, at least since MacPherson v. Buick Motor Co. (217 N.Y. 382, 111 N.E. 1050) in 1916. By 1960, manufacturers' duty had clearly been extended well beyond explicit contractual linkages to include anyone likely to use or be exposed to a product as part of a string of "fictional contracts" (Rowley 1989: 380). Then, in Henningsen v. Bloomfield Motors, Inc. (32 N.J. 358, 161 A.2d 69 (1960)) a manufacturer was declared to be liable under an "implied warranty principle," for the first time in a product case, despite the lack of any convincing evidence of negligence by the manufacturer, or of any defect, and no expressed contractual warranty covering the claimed failure of the product. This implied warranty principle contributed to the movement away from a negligence standard of tort liability itself toward strict liability as subsequently established for California common law in Greenman v. Yuba Power Products (59 Cal. 2d 57, 27 Cal. Rptr. 697, 377 P. 2d 897 (1963)). Under strict liability, the product liability issue no longer has to be rationalized in "contractual" terms like "implied warranty". The doctrine serves as a transfer mechanism intended to aid those who are injured by imposing the costs on those who are believed to have deep pockets, regardless of fault. A short time later, a contractual limitation of a warranty was explicitly rejected (Vandermark v. Ford Motor Co. 61 Cal. 2d 256, 37 Cal. Rptr. 896, 391 P. 2d 168 (1964)): the obligations assumed by contract were declared to be immaterial, as the seller was subject to strict liability. Thus, the potential for contracting around inefficient statutes and court made rulings regarding

product liability has been significantly limited if not eliminated, at least in California, but the California position on strict liability has also been emulated in many other states.

Product liability has shifted from contract law to tort law through a process that Epstein (1982: 46) characterizes as "unsystematic and unthinking judicial activism." Some economists have argued that strict liability is desirable because it is a clear rule for classes of economic agents (manufacturers) who now know for sure what they are liable for [e.g., Rizzo (1980)]. Thus, administration costs should fall. In reality, however, the increasing application of strict liability [along with growing damage awards for intangible harms such as "pain and suffering" or anxiety over the possibility of getting cancer and as punishment, and reduced requirements of actually proof of cause in fact—see Benson (1996)] have made the property rights to producers' income increasingly insecure. These rights are "up for grabs" for anyone who can establish a claim, and this has lead to a rent-seeking type race for property rights accompanied by tremendous dissipation of wealth (Benson 1996). Since 1960, product liability tort litigation has exploded and entire domestic industries are threatened with extinction (Benson 1996). Consider American manufacturers of small airplanes who once dominated the world market: the numbers of planes manufactured in the U.S. has fallen from over 17,000 in 1978 to under 600 in 1993, as over 100,000 jobs have been lost, primarily because of product liability tort costs (Benson 1996). Between 1989 and 1992, for instance, 203 crashes of Beech aircraft were caused by weather, faulty maintenance, pilot error, or air-control mishaps, according to National Transportation Safety Board investigations, but every one of these crashes resulted in product-liability tort suits. Beech spent an average of $530,000 defending itself in these cases. Even those that are dismissed cost the company an average of $200,000 to prepare for. The other firms in this industry face similar litigation loads. And this is only one example of the "tortification of contract" (Olsen 1992) which has been "driven by attorneys in search of high expected rents from increased litigation, supported by legal scholars of interventionist predilections and by judges and juries whose social consciences too frequently led to changes in precedents conducive to a flood-tide of litigation and to the widespread shift from consent to coercion in the law of accidents and personal injury" (Rowley 1989: 379).

Not surprisingly, manufacturers are exploring many margins in an effort to re-establish property rights to their income. In addition to vigorous litigation in an effort to introduce new defenses against strict liability (e.g., assumption of risk defenses, unforeseen misuse defenses), growing liability insurance premiums, and substantial disinvestment in many vulnerable industries, business interests have lobbied hard for legislation to overturn judicial legislation. Some limitations have been passed (e.g., a 1993 federal statute bars suits against small-plane manufacturers after a plane and its parts have been in service for 18 years), despite strong opposition from the Association of Trial Lawyers of America. But trial lawyers are the largest benefactors of the growing tort law transfer process [a Rand Corporation study reported that the total money transferred in asbestos tort activity through 2000 had reached $54 billion, but plaintiffs were estimated to have netted about $21 billion after paying legal fees, with the other $33 billion, about 63 percent of the total, spent in the litigation and negotiation processes (Carroll, et al. 2002); i.e., for the most part, captured by plaintiff and defense attorneys], and they are also a very powerful and effective lobby group (perhaps the most powerful in the country), so they have generally been successful in countering demands made by business groups for tort reform.

Clearly, even within the United States, the ability to contract around state-made rules can be limited through state action. Barriers to contractual nullification are still much less significant in the U.S. than in many parts of the world, however, and as a result,

economies within many jurisdictions are much less robust than the U.S. economy has been.

4. Conclusions: can contractual nullification work for emerging economies?

Many of the so-called emerging market economies in parts of Eastern Europe, Asia, South and Central American, and Africa clearly are not emerging very rapidly. Indeed, some economies are stagnant or declining. While "experts" point to many factors, a growing number of political, economic, and legal consultants and academics recognize that the slow pace of development is a function of the institutional environment. In particular, they note that legal systems in these countries often do not support private property rights or enforce contracts. Thus, many of these consultants and academics contend that the states must step up their efforts to establish commercial law. These arguments ranges from sweeping proposals to write all-encompassing commercial codes (Ioffe 1996), perhaps by copying the codes that exist elsewhere (Izdebski 1996), to focusing on the "core tasks of liberal governance" such as protection of property rights along with clarification and uniform application of contract law (Dempsey and Lukas 1998: 472), to explicit state recognition and enforcement of existing international norms (Boguslavskii 1996: 421). In reality, however, less state involvement in commercial law is called for at this stage of market development, not more (Rudden 1996: 44; McMillan and Woodruff 1998; Pejovich 1995, 1997; Benson 1999b). As Feldbrugge (1996: 568–569) notes in an understated way,

> The construction of a totalitarian system entailed the systematic destruction of the civil society and the free market system; the end of totalitarianism raises the question whether the road can also be traversed in the opposite direction. In a country like Russia, the historical tradition, the instincts of the leaders, the urgency of the problems all suggest a positive answer: the political leadership, the government, is considered to be responsible for reintroducing a free market economy and laying the foundation for the emergence of a civil society. . . . There is some reason to look critically at such a view. . . . There is something incongruous about the planned approach to the abolition of the planned economy and its replacement by another economic system.[32]

Feldbrugge is correct, of course. First, totalitarian systems tend to destroy "civil society" including the mechanisms for trust and private recourse that allow contractual nullification of the rules created by the totalitarian government. Second, when a totalitarian government also destroys most market institutions, as the Soviet Union and its satellites did, the potential for contractual nullification is even more severely undermined. The merchant community that exists when such a government arises may choose to leave if they can, rather than staying and employing contracts to reduce the government's impact. For instance, under the most successful imperial dynasties in China, a large portion of the Chinese merchant community became involved in Indian Ocean trade as "one of the most advanced entrepreneurial groups in Asia was forced to operate outside the reach of the state system and to create its own self-protection" (Chaudhuri 1985: 208). If and when the government falls, very few individuals remain with the incentives or knowledge that might lead to a rapid development of the civil-society or market-related institutions of trust and private recourse. In other words, economies that are burdened by strong authoritarian anti-market governments cannot be expected to be

[32] In light of the continued belief in Russia that the state must be the source of the rules that shape the economy, it should not be surprising that a "jungle of state control" exists there, "parading under the banners of reform or democracy" (Simons 1996: 263). The same is true to a greater lesser degree in many of the former communist block countries and many other countries around the world (de Soto 2004). The resulting law inevitable has conflicting objectives (Benson 1999a).

robust, but neither can economies that are attempting to emerge after such governments have been eliminated, at least for a while. These emerging economies have to grow new civil and commercial societies so they can effectively nullify the rules created by these states.

Imposed socialism, communism or some other form of centralized economic decision making is not the only way to destroy markets and the systems of trust and private recourse that underlie them, of course. A predatory state that arbitrarily or opportunistically levies heavy taxes on economic activity can do the same thing. If the quasi-rents associated with developing reputations and repeated dealings can be appropriated by the state, for instance the ability to develop effective non-violent private sanctions are weak. 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 [customary] rules. . . . [Even though communism has presumably been eliminated] most countries in Eastern Europe are arbitrary states."

Taylor (1982: 65) notes, however, that the basic cooperative means of maintaining social order, trust and private recourse, often survive even under strong centralized authoritarian rule, although they may exist in "atrophied and attenuated forms." Numerous examples of arbitrary coercive systems can be cited where "parallel" predominately cooperative systems of norms and institutions actually dominate many and at times even most interactions (e.g., de Soto 1989; Nee 1998: 88). Voluntary forms of economic activities may have to be moved "underground" in order to produce wealth within such an economy and protect the wealth that is created. Cooperative groups arrangements are likely to persist, but the fact that they must avoid detection and/or measurement will tend to alter their characteristics relative to an unhindered voluntary community. De Soto's (1989) detailed analysis of the "informal" sector in Peru is particularly revealing in this regard, as he explains that the "squatter communities" are very well organized, that members respect each other's property claims, cooperate to enforce rules of behavior, and so on. Nonetheless, the existence of an arbitrary coercive government raises transaction costs for such groups. For instance, ostracism is less effective when property rights are tenuous due to the threat posed by an arbitrary government, making time horizons short and reputations less valuable. If prudent morality is ineffective the victim may opt for retributive morality. Cooperative communities may still aid the victim in the "illegal vigilante" exaction of retribution, of course. Under such circumstances, a considerable amount of "crime" may be "undertaken to exercise social control" (Ellickson 1991: 213; also see de Soto (1989)). Furthermore, since commitment making tends to be chilled, retributive morality may not even be able to support cooperation in many situations where it could under other circumstances.

Even if the national governments with claimed jurisdictions over emerging (as well as stagnant or declining) economies were to suddenly become mush less arbitrary and decided to exclusively focuse on making and enforcing rules that would facilitate the development of market economies (rather than on wealth transfer issues and rent extraction by corrupt officials), it does not follow that they would be the best source of those rules and governance institutions. If we look to Western Europe and North America for models of how robust economies emerge, then we must recognize that markets were well established and governed by private institutions of trust and recourse long before the states got involved in the making and enforcing of rules of commerce, as noted above. Furthermore, even when the states did begin to assert a role in governing commerce, they generally started by recognizing established custom (Benson 1989, 1995). The Eastern European (and perhaps Asian) economies emerging from communism, and the African, Latin American, and Asian economies subject to the rule of arbitrary governments are not able to start with the types of trade associations

and other private organizations that have provided the foundation for customary commercial law in the U.S. and in much of Western Europe, but Western Europe did not have them either, until they became desirable. In medieval Europe, for instance, when authoritarian kings were gaining power over relatively small nations (relative to the Soviet Union), the international merchant community established its own rules, *lex mercatoria* or the "Law Merchant", consisting of rapidly evolving customary norms, and disputes were resolved in the merchants' own courts (Berman 1983, Trakman 1983, Benson 1989). Strong incentives to cooperate through exchange, to live up to promises, to respect one another's property rights, and to supported an unbiased and fair dispute resolution system arose because of positive benefits associated with repeated dealing reciprocities and reputation effects, and because of the potential for ostracism. Modern international commercial law remains as a largely voluntarily produced and enforced system of spontaneously evolving norms (Benson 1999b), despite many attempts by various coercive governments (some supported by politically powerful merchants seeking special privileges) to subjugate it over the centuries (Benson 1989). The relative mobility of merchant wealth limited the ability of governments to impose their rules on commerce. Like the merchants who left China, European merchants could leave a country that attempted to limit their contractual activities, so kings who wanted to attract and tax commercial wealth found themselves constrained, at least to a degree. Thus, as Hayek (1973: 81–82) explains, "The growth of the purpose-independent rules of conduct which can produce a spontaneous order will . . . often have taken place in conflict with the aims of the rulers who tended to try to turn their domain into an organization proper. It is in the *ius gentium*, the law merchant, and the practices of the ports and fairs that we must chiefly seek the steps in the evolution of law which ultimately made an open society possible." Throughout Western European history, it has been the international merchant community that has probably been the most successful at sustaining the potential for contractual nullification. A similar phenomenon has characterized the United States wherein state governments compete with each other to attract commercial activity and its associated tax base. This competition includes fiscal policy dimensions (taxation, spending) (Benson 2000b), but it also involves positive law. For instance, Ribstein (2005: 5) notes that in a federal system "those who are affected by business organization statutes can either contract around them or exit at low cost." Exit is possible because "firms can avoid organization law simply by choosing their state of organization. It follows that, in such a system, organization *law* has less influence in shaping firms than underlying *economic* constraints on organization form" (Ribstein 2005: 3).

The evolution of the private institutions of commercial law and of market institutions themselves has always been simultaneous rather than sequential (Benson 1989). As the conditions of commerce change, institutions evolve, and this in turn leads to more commercial developments and more legal evolution. In this regard, it is not surprising to find that informal and even formal groups of trading partners are developing quite rapidly in places like Poland, Hungary, the Czech Republic, and even Vietnam (Pejovich 1995, McMillan and Woodruff 1998), much as they did in North America during the colonial period and Western expansion when the state was unable to provide protection for property rights and unwilling to enforce contracts (Benson 1991b, 1995).[33] Some of these institutions are developing

[33] Many entrepreneurs also have turned to private protection services that secure their property and enforce their contracts (Pejovich 1995; Dempsey and Lukas 1998: 470), much as medieval merchants had to do as they began to trade across political boundaries during the formative period of the Law Merchant (Benson 1989, 1998c). There were roughly 10,000 private security firms registered in Russia in 1998, for instance, and experts suggest that there are actually as many as 30,000 such firms (Dempsey and Lukas 1998). One reason for this is the threat to businessmen posed by organized crime in Russia, of course, as Dempsey and

to the point that they can offer and back arbitration. After all, entrepreneurs in emerging market economies who enter international markets are being introduced to the modern Law Merchant's customary commercial law and its institutions for governance (private arbitration, information channels and ostracism, etc.),[34] International traders who see the benefits of such arrangements can attempt to emulate them in their domestic dealings. And indeed, parties to domestic contracts in some of the emerging economies are beginning to turn to arbitration when disputes arise, even when they have to find arbitrators outside their own countries to do so. Thus, even the level of state involvement with commercial law associated with providing legal sanction to arbitration could mean that Eastern European and Asian merchants may never develop the kinds of practices and usage that are necessary to support robust economies. As Rudden (1996: 44) explains, the state simply must shrink as "Many of its functions are to be taken over by persons, human and corporate, of private law, and it will go hard with them if they are not permitted in good faith to set aside the application of the standard legal patterns." The withdrawal of the state from any efforts to influence commerce is likely to do more to stimulate robust economic activity than any proactive efforts by the state to speed up the process (Benson 1999b).

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Lukas (1998: 471) suggest, but organized crime can also be a source of contract enforcement and protection of property rights (Pejovich 1995). In this regard, Pejovich (1995: 24) even suggests that "the mafia might end up doing more for Russian people than their current government." This may not be incorrect since one of the major threats to business can be the state, and the mafia can be seen as a competitive alternative to the state (Gambetta 1983). Thus, for instance, many Russian businesses turn to mafia groups to evade excessively high taxes and overly restrictive regulations (Dempsey and Lukas 1998: 471).

[34] In fact, many may already be familiar with international arbitration, as it was regularly employed under the communist regimes by state owned enterprises involved in international trade (Böckstiegal 1984: 15) [although their perception of the benefits of arbitration might be colored if this is the source of their experience: arbitration with a state-owned enterprise tends to be "very slow moving" and perhaps less likely to be enforceable (Böckstiegal 1984: 22–23, 49–50)].

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