Customary Law and Economics

Edited by
Lisa Bernstein and **Francesco Parisi**

ECONOMIC APPROACHES TO LAW 42

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Introduction

Lisa Bernstein and Francesco Parisi

This volume brings together several seminal works on customary law, a subject of much contemporary relevance given the impact it has had on modern international law, recent developments in commercial law, and the legal reforms of transition economies. Although scholars in law, economics, and history have provided a wealth of research on the subject—as the essays in this volume amply demonstrate—the issues arising from the intersection of customs and the law are far from settled. To the contrary, the field remains rife with controversy over even the most fundamental questions, such as whether 'customary norms' exist, and, if they do, what role they ought to play in the development of positive law and the adjudication of particular cases.

Persistent disagreement over these foundational issues is in some sense unsurprising; custom is a unique phenomenon and resists analogy to other sources of law. Unlike legislation or judge-made law, customary law emerges spontaneously from the behavior of community members, who contribute directly to its formation through their individual and often uncoordinated decisions. When community members engage in recurring patterns of behavior, they contribute to the development of nascent, unarticulated rules, which, if recognized by the law, may eventually govern their future interactions. This process, which may be described as a sort of 'direct legislation through action,' differs from traditional lawmaking processes, which generate law through formal (and often institutionally centralized) mechanisms, such as legislation, treaties, and court decisions.

This volume is divided into three parts. Part I examines a variety of perspectives on the history of customary law, a subject that has generated many intense debates. Part II begins by presenting several case studies that explore the role and limits of customary systems in a variety of commercial settings. Along the way it focuses on defining the proper relationship between law and custom from a variety of legal and economic perspectives. It concludes with a discussion of a game-theoretic approach to thinking about the generation of customary norms and how the state might go about distinguishing those norms it wants to incorporate into the law from those it wishes to ignore. Part III explores the role of custom in international law, where it is acutely important, from a similarly broad set of analytical viewpoints.

Part I Customary Law: Historical Illustrations

This part begins with two pieces that put forth highly conflicting stories of the evolution and operation of the Medieval Law Merchant.

Benson (1989, Chapter 1) describes the Middle Ages as the halcyon period of spontaneous order that emerges outside the law, while Kadens (2012, Chapter 2) describes it as a period where merchants themselves wanted the state to play a much greater role in regulating and

adjudicating the terms of exchange. Which of these conflicting accounts of the Law Merchant is more accurate is a question of contemporary relevance not mere historical curiosity. The view of the Law Merchant advanced by Benson is the only empirical evidence supporting the assumptions underlying the adjudicative approaches in the three most important sales law statues in the world—the Uniform Commercial Code, the United Nations Convention on the International Sale of Goods, and the recently proposed Common European Sales Law—all of which take for granted that the types of usages of trade that Benson claims governed trade in the Middle Ages exist and remain an important force in commerce today. In addition, Benson's account continues to play a central role in justifying legal reform proposals—particularly in transition economies and developing economies—that are designed to support trade and improve the functioning of nascent legal systems. As a consequence, if the Benson account is indeed flawed, the implication for the design of modern legal systems may be significant.

Benson provides an account of trade in the Middle Ages that emphasizes the 'spontaneous evolution' of commercial customs and highlights the adjudicatory institutions that arose without any state intervention to facilitate trade both within particular localities and across national boundaries. He describes a system of well-functioning, entirely private, merchant courts that resolved disputes between traders on the basis of substantive transnational usages known to all merchants, a system that in his view 'voluntarily produced, voluntarily adjudicated, and voluntarily enforced' a privately generated Law Merchant of sales within the merchant community (p. 647).

Looking at the same period, and drawing on new archival research, Kadens argues that the Law Merchant described by Benson is nothing but a 'myth' that has been seized on by advocates of private ordering. She argues that the Law Merchant described by Benson never actually existed, at least with respect to the law of sales. Kadens contends that many of the functions attributed to generally known usages of trade were actually carried out by written contracts together with the use of brokers, notaries, and other transactional intermediaries, with occasional support from state legal systems. She documents that while there is considerable evidence that a substantive Law Merchant relating to bills of exchange existed, there is no evidence to support Benson's claim that there was a substantive Law Merchant consisting of sales customs and usages. Kadens concludes that, 'we lack evidence that [sales-related gap filling customs] became a uniform and universal part of the *lex mercatoria* other than, perhaps, at a very high level of generality. Instead, the evidence suggests that substantive customs remained geographically local or confined to a particular network of repeat players' (p. 1177).

The historical exploration of the Law Merchant concludes with Trakman's (1983) account (Chapter 3) that emphasizes the role of both the Law Merchant and the state in supporting trade during the twelfth and thirteenth centuries, and Klerman's (2009) account (Chapter 4) of the ways that starting in the thirteenth century, England sought to encourage trade by making changes to its legal system that were designed to create a more level playing field between domestic and foreign merchants, thereby suggesting that the expansion of trade that took place in the Middle Ages was nowise devoid of state support and influence.

The two pieces that follow (Grief et al. 1994, Chapter 5 and Milgrom et al. 1990, Chapter 6) draw on game theory to explore the ways that the type of system Benson describes would have been able to provide a workable framework for supporting trade and promoting commercial cooperation. Their focus is on the structural features of the private institutions (such as merchants' guilds) that enabled trade to thrive. Although they adopt the basics of the Benson version of

history, they are careful to note that the state may have played slightly larger role in the success of these systems—through both its actions and inactions—than is often assumed.

In sum, the articles in this part were chosen to acquaint the reader with the historical debates over the existence, content, and structure of the Medieval Law Merchant that are most relevant to contemporary policy debates.

Part II Commercial Customary Law

The articles in this part explore two prominent themes in the literature on customary law: (1) the preconditions that can facilitate trade and lead to the emergence of customary norms, including social or ethnic homogeneity, repeat dealing relationships, and transactions that occur within relatively small groups, together with the role that institutions (as opposed to the type of spontaneous order discussed by Benson) can play in the encouraging the emergence of these norms, and (2) the role that reputational effects and non-legal sanctions play in contexts where contracts are interpreted and enforced outside of the public legal system.

The first piece, Landa (1981, Chapter 7), explores the role that ethnically homogeneous middlemen can play in the development of trade. Landa's insights into the role and functions played by middlemen are similar to those identified by Kadens (2012, Chapter 2). Although Kadens and Landa focus on vastly different historical and ethnic contexts, both authors provide a richly detailed account of the ways that face-to-face trade between middlemen who are repeat players in the relevant market can overcome some of the barriers to trade created by geographical distance and differing norms. The role of ethnic homogeneity (and its attendant social institutions) in supporting trade is also the focus of Bernstein (1992, Chapter 8), which explores how the diamond industry in general, and the New York Diamond Dealers Club in particular, created institutions and information intermediaries that drew on the close religious and social ties among diamond dealers and their families to increase the reputational harm transactors would suffer if they failed to meet their commercial commitments.

The next piece, Bernstein (1996, Chapter 9), explores the private legal system created by the National Grain and Feed Association. This system provides association members with a clear set of industry specific contract default rules and access to the group's private arbitration system where disputes are resolved by panels of merchant arbitrators who adopt a very formalistic approach to adjudication that only looks to usages when both the parties' contract and the group's rules are entirely silent on an issue. The piece demonstrates that while the grain industry is not characterized by the types of deep social and religious ties that characterize the diamond trade in New York, the group has adopted membership rules, adjudicatory mechanisms, and reputational information intermediaries that enable its members to obtain many of the benefits of socially mediated trade.

Set against Bernstein's description of a private merchant court is Feldman's (2006) piece on the Tokyo Tuna Courts (Chapter 10). In this piece, Feldman shows that industry-specific legal systems can also function effectively when they are under the auspices of a government. He finds that tuna traders vastly prefer to be governed by a set of clear bright line rules, rather than a system of unwritten customs. His finding are therefore quite consistent with Bernstein's grain and feed study, which also revealed transactors' marked preferences for formal adjudicatory institutions operating under clear and codified substantive and procedural rules.

The next two pieces, Bernstein (1999, Chapter 11) and Cooter (1994, Chapter 12), explore custom creation. Bernstein explores the attempts of trade associations in several industries to codify their customs into written trade rules. Her case studies illustrate that when merchants set out to do this, they discovered that usages varied quite widely, both across trading areas and even within some very local areas. Although these groups did ultimately 'codify' sets of trading rules, this was not accomplished through the codification of existing and widely accepted customs and usages, but rather through a quasi-legislative process that looked to both variant practices and policy arguments to decide on the most appropriate terms of trade. Taken together, Bernstein's studies raise serious questions about whether usages of trade actually exist in merchant communities. Her findings echo those of Kadens (2012, Chapter 2)—some local usages existed, but they were very local, and the few more widely known usages that existed were typically too vague or general to be useful in deciding particular cases.

Cooter (1994, Chapter 12) is interesting to read against the background of Bernstein (1992, Chapter 8; 1996, Chapter 9; 1999, Chapter 11), Kadens (2012, Chapter 2) and Benson (1989, Chapter 1). It recognizes that different norms arise in different ways, and suggests that before the law gives deference to social norms and customary usages it should draw on evolutionary game theory to analyze the structural processes through which they emerge. Cooter concludes that,

> a common law court should find that a social norm is law if it evolved from an appropriate incentive structure. An appropriate incentive structure is one in which incentives from signaling by individuals align with the public good ... Social norms that evolve from an appropriate incentive structure already have the community's authority in them. Recovering this conception grows more urgent as the economy's complexity increases. (p. 227)

The part concludes with Ellickson's (1989) seminal study of whaling norms during the period 1750–1870 (Chapter 13). This study was an early contribution to the legal literature on social norms, and provides a broad framework for thinking about the role that norms can (and often do) play in regulating behavior.

Part III International Customary Law

Historically, customary law played a fundamental role as one of the main sources of public international law, spawning a large majority of the rules that govern the external rights and duties of sovereign nations. In this part, we collect research that explores the formation, evolution, and efficiency of customary international law from a variety of interdisciplinary perspectives.

The notion of custom plays a central role in contemporary international law scholarship. The first readings in this part reveal that many of the issues in customary international law have important parallels in the literature on custom and contracting. The first three pieces, Posner and Sykes (2013, Chapter 14) and Goldsmith and Posner (1999, Chapter 15 and 2000, Chapter 16), draw on rational choice principles to explain the similarities and differences between new and old customary international law. They also both seek to explain the behavior of states and explore the emergence of cooperative norms in a variety of customary international law contexts. The part then turns to the work of Kontorovich (2006, Chapter 17), who explores the

reasons why international law customs may not always evolve towards efficiency and may therefore fail to effect an improvement in social welfare.

Posner and Sykes (2013, Chapter 14) draw on rational choice and game theory to explore patterns of cooperative behavior of nation states—there frequent decisions to sacrifice short-term interests in order to become 'mutually better off in the long term' (p. 61). They conclude that for states to agree to cooperative behavior, these norms must be optimal—that is, in the private interest of the states—as well as sustainable (in the sense that self-interested parties will reciprocally adhere to them).

Goldsmith and Posner (1999, Chapter 15) changed the terms of the debate over international customary law. It was the first piece to adopt an explicitly economic perspective on international customary law, a topic that had long been studied exclusively by international law scholars. Goldsmith and Posner reject the traditional legal framing of customary international law and suggest that states' compliance with the norms of customary international law may be better explained in terms of the political self-interest of nations. The authors use concepts from game theory to challenge the essentialness of '*opinion juris*,' which mainstream scholarship then regarded as the cornerstone of customary international law, as well as to undermine the claim that state compliance with customary law arises from a sense of legal obligation. Goldsmith and Posner argue that self-interest affects states' compliance with customary international law far more than abstract beliefs about *opinion juris*. The authors provide three illustrations (on neutrality, diplomatic immunity, and maritime jurisdiction) to suggest that the multilateral state practices that give rise to customary international law are entirely (or nearly entirely) the product of self-interest. These arguments are further elaborated in Goldsmith and Posner (2000, Chapter 16), which challenges the conventional belief that customary international law has prescriptive force capable of influencing the behavior of sovereign states. Goldsmith and Posner, in essence, view customary international law as a descriptive and declaratory source of international law, which reflects patterns of behavior that states follow because it is in their best interests, not because they embody shared values of the 'international community.'

Echoing the analysis of Cooter (1994, Chapter 7) from Part II, Kontorovich (2006, Chapter 17) powerfully challenges the assumption that customary international law will tend to be efficient. Kontorovich suggests that when rules of customary international law promote the welfare of a group of states, these norms are considered desirable, and that where welfare and desirability do not coincide, 'there is little reason to expect that international customs will improve states' joint welfare' (p. 863). Kontorovich concludes that the standards for establishing customary international law should fluctuate based on the substantive context and the groups of states whose interests are implicated (p. 877), given that international customs might well have evolved inefficiently—a conclusion that generalizes from Cooter's (1994) contract interpretation discussion (Chapter 7).

The final three articles offer a more optimistic view of the formation of customary international law, examining the meta-rules that govern the formation and evolution of customary international law. Custom ordinarily creates binding rules on all states; the legal force of customary international law hinges upon the idea that states cannot unilaterally violate an existing rule of international law. However, states may be exempt from an undesirable (to the objecting state) rule if they oppose the emerging custom or, under certain circumstances, if they opt out of existing customs. Fon and Parisi (2009, Chapter 18) and Bradley and Gulati (2010, Chapter 19) consider the mechanisms through which states can avoid the binding force

of an emerging custom or depart from an already established rule of customary international law. Two legal doctrines allow states to nullify the binding effect of customs: the 'persistent objector' and 'subsequent objector' doctrines, which become especially significant when customary rules emerge from sets of states with heterogeneous needs and preferences. According to the persistent objector doctrine, states may raise a timely and persistent objection to an emerging rule of customary law to gain either partial or total exemption from the opposed custom. Conversely, the subsequent objector doctrine applies when states depart from an already established rule of customary law. Under the subsequent objector doctrine, states are allowed to depart from an existing rule of customary law by securing the acquiescence of other states.

Fon and Parisi (2009, Chapter 20) consider the effect of the persistent objector and subsequent objector doctrines on the process of formation and evolution of efficient customary law, showing how these doctrines effectively allow customary international law to change over time, contingent upon the changing preferences of the participating states, avoiding the risk of 'opportunistic departures from existing custom motivated by myopic attempts to avoid the immediate costs of compliance with existing customary law' (p. 308).

Bradley and Gulati (2010, Chapter 19) look at the subsequent objector doctrine, contrasting it to the 'mandatory view' of customary international law—that nations do not have the legal right to withdraw unilaterally from an established customary rule. While recognizing the need to restrict opt-out options in some areas of customary international law, Bradley and Gulati argue that this fails to justify the mandatory view as a uniform approach to customary international law. The authors note the 'puzzling feature' of the 'blanket disallowance of any subsequent opt-out right,' in customary international law, which they find 'particularly striking in light of the widespread withdrawal rights available under treaty law,' which given the similar consensual foundations of treaties and customary international law is surprising (p. 275). Bradley and Gulati further suggest that the mandatory view may have arisen from an effort by developed Western nations to bind less powerful states to customs, which predominantly benefit the more powerful nations (p. 226).

We conclude the collection with an analysis of articulation doctrines in the formation of customary law. Practice and *opinion juris* stand as the only required formative elements of custom. However, the statements and expressions of belief that states make in conjunction with state practice play an important informal role in the formation of custom. According to articulation theories, when searching for a rule of customary international law, courts should pay special attention to the official statements and expressions of belief of the relevant state actors to ascertain the actual nature of a state practice. Parisi and Fon (2009, Chapter 20) discuss articulation theories and their impact on custom formation. Through articulation, states can specify the reasons why they engage in a given practice and narrow down the content of the rule that they intended to follow through their action. Articulation gives some objectivity to the otherwise intangible and ambiguous element of *opinio juris*. Further, articulation provides a way for states to pre-commit to the content and the future interpretation of an emerging custom. Parisi and Fon assess the participation and effort incentives of states under conditions of uncertainty and show how articulation affects the formation and recognition of customary international law, identifying the advantage of articulation in mitigating the strategic problems in custom formation.

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Contents

Part I
Customary Law: Historical Illustrations

[1]

The Spontaneous Evolution of Commercial Law*

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I. Introduction

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

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

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

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