THE LAW MERCHANT:
The Evolution of Commercial Law

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To
Michelle, Jeanne and Shannon

Preface

THE PRINCIPLE OF FREE TRADE HAS PREVAILED IN LAW FOR CENTURIES. As a legal concept, freedom to contract has signified the dominance of the libertarian notion of *laissez-faire* over government intervention in business affairs. Evolving out of the economic theory of perfect competition and philosophical conceptions of free will, this sanctification of the business process has matured into a central tenet of the law governing international trade. Merchants engaged in world trade are to be free to transact business across national boundaries in accordance with their own trade design.

Yet the notion of "freedom to contract" has come under increasing fire. Motivated by a rising awareness of imperfect competition in human affairs and a philosophical suspicion of man's capacity to regulate his own dealings by way of accord, adjudicators have sometimes relaxed their vigilant consecration of international bargains. Judges have granted excuses from obligations, not because international merchants so agreed, but because the court considered such a remedy to be appropriate in the circumstances. Nonperformance has been permitted by law on the grounds that the disruption in performance allegedly arose unexpectedly and had devastating effects upon performance, beyond the control of the parties.

This book proposes that the legal diminution of the freedom to transact across national boundaries undermines the autonomy of business obligations. To permit judicial interference with private international

agreements is to disregard the internal capability of the agreement, the marketplace and the trade to regulate international business bargains.

Each chapter is geared towards these ends. Chapters 1, 2 and 3 stress the geographic, linguistic and legal barriers to trade that are encountered in transregional trade and the manner in which international merchants overcome these obstacles. Extending from medieval (Chapter 1) to modern times, (Chapters 2 and 3), they highlight the capacity of international merchants to develop uniform customs and usages to regulate their business ventures. Thereafter, Chapter 4 presents a sociological analysis of the methods that are applied by multinational oil companies to regulate nonperformance in international crude oil sales. Evolving out of a questionnaire submitted to, and interviews held with, inside legal counsel, this study examines the manner in which multinational crude oil contractors regulate and resolve contractual disputes arising from the nonperformance of their sale obligations. Chapters 5 and 6 then emphasize the difficulties that are faced by common law courts in the interpretation of international business agreements. They stress the diverse legal methods that are used by common law courts to construct legal excuses from performance (Chapter 5); and they criticize the recourse of courts to legal fictions in order to strike down business bargains (Chapter 6). In the conclusion, the book contends that free trade has traditionally served as the foundation of international business law and should continue so to serve if national and international legal systems are to respond to, rather than hinder, the progress of world trade.

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THIS BOOK HAS DRAWN, IN SOME MEASURE, FROM A SERIES OF MY articles: in particular, *The Evolution of the Law Merchant: Our Forgotten Heritage,* 12 J. of Maritime L. & Com. 1,153 (1980-81); *Interpreting Contracts: A Common Law Dilemma,* 59 Canadian B. Rev. 241 (1981); *The Nonperformance of Obligations in International Contracts for the Sale of Goods,* 29 Oil & Gas Tax Q. 716 (1981); and *Legal Fictions and Frustrated Contracts,* 47 Mod. L. Rev. (1983).

Segments of the book were presented as papers at consecutive meetings of the Association of American Law Schools. Among these were "International Oil Contracting," presented in Pheonix, Arizona (January 1980); and "The History of Commercial Law: Past, Present & Future," delivered in San Antonio, Texas (January, 1981).

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Contents

Introduction

FOR CENTURIES THE SANCTITY OF CONTRACTS HAS DOMINATED THE regime of international trade. The agreements of merchants have been respected as a matter of sound business sense. Various reasons account for this legal sanctification of commercial freedom. Merchants in the sophisticated domain of international trade generally appreciate the nature of their own needs and the capacity of the international market to satisfy them. Indeed, their very survival in the marketplace demands that they balance together market supply and market demand, price and competition in determining the nature of their bargains. Merchants decide with whom they wish to contract and upon what terms; they determine the limits of their own requirements; and they establish the parameters of their obligations. They do so themselves. The law does not fulfill such functions for them. Within this context, the sanctity of their bargain is not merely a legal privilege; it is a commercial necessity. The business agreement, construed against the background of similar international agreements, is the most effective means towards interpersonal harmony in international trade. The contract is devised as a matter of the free will of the parties; it is reciprocal in intent; and it is adaptable in its scope of application.

The focal point of free trade therefore lies in the interaction among three concepts: marketplace, agreement and time. The marketplace is the environment in which free trade takes place. Here, merchants meet in order to exchange goods and services. Here they create the business conditions that underlie their free trade; and here they manifest their good

or bad faith as members of the business community. The agreement is the instrument of commercial interaction. It prescribes when performance is owed and when it should be excused, how it should be rendered and in what conditions it should be modified. Time is the link between market and agreement. The advent of time fosters the growth of inter-party practices. Time permits practices to crystallize into business usage and ultimately into trade custom.

Continuing experience in world trade provides a tested environment in which merchants can interact freely, choosing their trade partners and contract terms with an expanding awareness of both the marketplace and of one another. Together, market, agreement and time allow business instruments to evolve into uniform codes and documents, comprehensive in their terms and farsighted in their application to an ever-changing business world.

Even in medieval times there was abundant evidence of highly developed commercial instruments. Merchant practices gave rise to commercial paper, letters of credit and bills of exchange, all reflecting noticeable uniformity in character and design. Trading institutions were similarly well-advanced. Merchant guilds, country fairs and market cities evolved as major centers of free trade. Here merchants from Mediterranean Europe, Asia and Africa met to exchange goods and services; and here they developed their trading conventions.

Proceedings before Law Merchant tribunals had these features in common. Adjudication was essentially oral. Formal testimonies, written affidavits and extensive judgments were generally dispensed with as a matter of course. Commercial adjudicators took judicial notice of trade custom and business practice; and they avoided the delays that would otherwise arise from the administration of oaths, the tedious cross-examination of witnesses and the lengthy adjournment of proceedings.

Within this business domain, merchant institutions were translated into legal institutions. Codes of law operating at merchant centers embodied the custom of merchants; they reflected trade habits and market usages. Most importantly, in regulating transregional trade local influences subserved to the demands of the cosmopolitan trader. Such was the nature of the medieval law merchant.

This supremacy of commercial practice in the marketplace still prevails today. Just as the medieval merchants relied upon trade codes to govern their adventures, modern merchants rely on international codifications to facilitate conventional trade. Just as medieval law merchants faced the perils of the sea—storms, lightning and restraints of princes—modern trade is similarly threatened by the Acts of God and man alike. Just as medieval merchants devised their own institutional means of allocating the risks of nonperformance, merchants today also rely upon a

combination of contract negotiations, industry custom and inter-party practice to resolve impediments to their performance. The self-sufficiency of the Law Merchant therefore retains its basic ingredients today as it did yesterday: it remains transregional in character, commercial in orientation, and expeditious in intent.

With the advent of time, the agreement and the marketplace have undoubtedly grown more extensive and more complex in their spheres of application. Both affect an ever-growing range of international transactions; and both act as effective restraints on merchant abuse in transregional business. Trade codes and business contracts, commercial documents and mercantile usages demonstrate the capacity of merchants to regulate their own business affairs. Commercial contracts display farsightedness in intent; they provide in detail for performance and for nonperformance, and they specify, in carefully drafted clauses, the extent of each party's obligations. So too, trade conventions assist in the formulation of agreements. General conditions of trade facilitate the drafting of terms, while documents of title, letters of credit and contracts of insurance all facilitate the process of trade itself.

Studies of industry usage reveal the sophistication of the international trade regime and the capacity of international merchants to adapt their trade agreement to meet the demands of interdisciplinary change. For instance, international contracts for the sale of crude oil illustrate how carefully multinational oil contractors provide for both performance and nonperformance within their performance adjustment and *force majeure* clauses. These clauses specify in cautious phraseology the conditions under which performance will be altered and nonperformance will be permitted. "War clauses" grant relief from performance in such events as riots, rebellions and revolutions; "strike clauses" provide for performance relief on the occurrence of debilitating strikes, lockout and "other labor disturbances." Each nonperformance provision is carefully worded; each is couched in qualifying language; and each evolves out of prior trade experience with the risks of nonperformance.

The terms of international crude oil agreements also reflect upon market forces. For instance, they generally incorporate by reference the "practices" of the crude oil industry. They provide for price-delivery terms that are suited to the specific demands of the oil industry; and they make express choices of law and jurisdiction in response to the economic-legal requirements of the parties.

In addition, international crude oil contracts of sale demonstrate their capacity to alter with the passing of time. Specific clauses deal with adjustments in performance in the face of altered market prices, partial failures of supply, and faltering demand. "Government take" and royalty tax clauses stipulate for the exigencies of government intervention; while

excuses from performance arise in the face of such specific events as oil embargoes, the requisition of oil tankers and the blockage of international waterways. Each new international hazard produces a new contract clause; and each new clause provides for a burden previously not dealt with in explicit contract form.

The law governing international trade also echoes the conventional needs of the merchant community in various ways. International codes incorporate the practices of merchants within their terms. Arbitration proceedings embody commercial understandings within their arbitral frameworks; while conciliators and mediators resolve international disputes over nonperformance by balancing the needs, interests and concerns of merchants.

In this way, the international legal order has responded to, not displaced, the business order. International business law has evolved as a suppletive, not a mandatory, system of legal rules. What merchants ought to do as a matter of business convention frequently determines what they ought to do in law.

The evolution of international adjudication therefore demonstrates an interdependence between commercial and legal practice. Adjudicators have realized increasingly that delays in adjudication cause a loss of business; formal proceedings keep businessmen away from their daily responsibilities; while complex legal proceedings complicate business.

Yet the International Law Merchant still faces fundamental obstacles in its evolution. The Law Merchant is no longer a uniform system. Its rules have been fragmented. Some are embodied in national jurisdictions and systems of law. Others exist in the regional or international domain. Absent a single set of Law Merchant principles, complex decisions must be made: should a universal system of commercial law be developed to govern international trade; or should the Law Merchant be fragmented in nature, varying from market to market, from region to region and from jurisdiction to jurisdiction?

Answering these questions raises further obstacles. International commerce and international law are different from domestic commerce and domestic law. Common law judges and lawyers are trained in indigenous law, not in the law of international trade. The rules of evidence and procedure which they employ are geared primarily towards domestic, not international, concerns. As a result, the need for speed and informality in international business will not always prevail in common law jurisdictions where judges are better equipped to deal with domestic rather than international commerce. Nor will justice prevail when judges are unduly preoccupied with applying local public policies and indigenous legal rules to transregional business.

Common law tribunals therefore require an understanding of the

international legal process; they need to appreciate the self-sufficiency of international merchants in their commercial adventures; and they are obliged to overcome their own domestic limitations. Their interpretation of international agreements should include knowledge of the international regime itself, the type of parties involved, the nature of the industry, and the impact of world trade upon each business venture. Most importantly, common law tribunals need to appreciate that international agreements are frequently the product of skillful planning and draftsmanship; their terms are deliberate in nature; and party perceptions of nonperformance are farsighted rather than narrow in scope of application. Any judicial construction of business obligations that disregards these business "facts" is likely to place undue reliance upon legal supposition in the interpretation of international practice.

Courts in common law jurisdictions have sometimes reacted to this dilemma in an innovative manner. They have developed methods of interpreting international contracts which are flexible in nature and adaptable in application. In regulating nonperformance, they have construed agreements in the light of the business context, encompassing both the practices of the parties and the social-economic and political dynamics surrounding such agreements.

Yet the constructive techniques used by common law courts have also given rise to difficulties of interpretation. Judges in the common law system have implied terms into contracts on the basis of their own perceptions of business "fact," even though judicial perceptions of business "fact" may well differ from the conceptions held by businessmen themselves. Even more problematic, common law courts have frequently added nonperformance terms into contracts on the basis of the judge's own construction of fairness and reasonableness, though the contracting parties, as merchants, might well have disagreed with the court in the circumstances. For example, courts have excused the performance of international sales obligations on the grounds that the "object" or "foundation" of the arrangement has been "frustrated," despite the promisor's undertaking to perform through a voluntary assumption of risk, and in spite of his capacity to regulate nonperformance risks by way of consent at the time of contracting.

The sufficiency of the common law as regulator of international trade hinges upon an awareness of the peculiar strengths of international business agreements. Such agreements are adaptable in nature, just as international practice is adaptable. They are farsighted in scope of operation, just as international transactors are farsighted; and they are well developed in character, just as international business is well developed.

In this way, the combined forces of the agreement, the market and time serve as a means towards self-government in transregional com-

merce. The autonomy of the contract subsists as more than an ideal; it is the end-product of an extensive historical development in the regime of international commerce.

1

The Medieval Law Merchant

That commonwealth of merchants hath always had a peculiar and proper law to rule and govern it; this law is called the Law Merchant whereof the law of all nations do take special knowledge.

Sir John Davies, The Question Concerning Impositions 10 (1656).

THROUGHOUT THE EVOLUTION OF THE LAW MERCHANT,[1] THE principle of good faith[2] appears as the bastion of international commerce. As Bewes explains in his *Romance of the Law Merchant*. '. . . [A]mong merchants good faith [is] . . . paramount.'[3] Human nature, the need for cooperation in trade, has ensured that merchants act with restraint in their mutual dealings. The risk of antagonizing a fellow merchant or losing a share of the market is a realistic reflection of business, whatever the commercial regime might comprise.[4]

No doubt, the continuity of exchange among merchants is attributable to some extent to '. . . fundamental decency [in] . . . the common man.'[5] More importantly, however, international trade has been motivated by the inspiration of need, mutual interest, and a fear of suffering business sanctions. Thus, although the form of mercantile transactions has changed over time, the structural underpinnings of international commerce have remained the same throughout all eras. Reciprocity in trade, enforced in suppletive law in terms of the principles of consent, has continued to prevail as the basis of commerciality.[6]

The Early Law Merchant

Custom, not law, has been the fulcrum of commerce since the origins of exchange.[7] From the earliest times, merchants have devised their own

business practices and regulated their own conduct. International trade law has been fostered by merchant custom.[8] For example, maritime trade in the Mediterranean for centuries has been based upon merchant traditions. The *Lex Rhodia* or Rhodian Law of the third century B.C. provided an ancient codification of merchant practice within the Mediterranean community.[9] Centuries later the same tradition prevailed. The Basilica, devised by the Eastern Emperor Basil I in the ninth century A.D., consisted of a collection of maritime rules arranged in systematic form.[10] More pronouncedly, the same time period yielded the Rhodian Sea Law, which embodied a comprehensive body of merchant customs that had developed at the mercantile center of the Island of Rhodes.[11]

The eleventh century heralded a localization of custom within specific regions. Towns and markets reduced local practices into regulatory codes.[12] Merchants began to transact business across local boundaries, transporting innovative practices in trade to foreign markets. The mobility of the merchant carried with it a mobility of local custom from region to region. The laws of particular towns, usually trade centers, inevitably grew into dominant codes of custom of trans-territorial proportions.[13] In this way, the customs of Barcelona, known as the *Consulato del Mare* (approximately 1340 A.D.) ascended as an internationally recognized body of mercantile custom. The island of Oléron in the twelfth century produced the famous Rolls of Oléron, which had a profound effect on the evolution of English Admiralty Law.[14] And the Laws of Wisby came into prominence as the third great commercial code of Europe several centuries later under Baltic influence.[15] Each of these codifications exemplified the localization of custom throughout the medieval world.

The needs of sea-borne traffic led to a distinctive creation which was to dominate European trade for centuries thereafter. This creation was the cosmopolitan Law Merchant, which gained ascendancy in the twelfth and thirteenth centuries. The Law Merchant reflected the ultimate move away from local law towards a universal system of law, based upon mercantile interests. ". . . [T]he distinguishing peculiarity of this medieval law merchant," Thayer wrote, "was . . . its cosmopolitan character, based on a common origin and a faithful reflection of the customs of merchants."[16] Gerard Malynes wrote in the Introduction to his now famed Law Merchant:[17] "I have intituled the Booke according to the ancient name of Lex Mercatoria and not Ius Mercatorum because it is customary Law approved by the authorities of all Kingdomes and Commonweales, and not a Law established by the Soveraigntie of any Prince."

The socio-economic features which typified this ancient Law Merchant also constituted the reasons for its subsistence. There was the underlying need to promote trade based upon freedom, subject to the need to pay a "just price" and subject to the need to avoid usurious

interest rates. Law which mandated the nature of trade beyond this arena would create economic loss, cause social disapproval and infringe upon public welfare. Rulers who sought by means of national law to rigidify this free commerce would inhibit the success of exchanges in the market place—to the loss of both the foreign and the local merchant community. The only law which could effectively enhance the activities of merchants under these conditions would be suppletive law, *i.e.*, law which recognized the capacity of merchants to regulate their own affairs through their customs, their usages, and their practices.

Actual law, where created, reflected precisely this commercial need. The *Consulato del Mare*, the Rolls of Oléron and the Laws of Wisby were a reflection of merchant desires, not legal commandments. "Out of his own needs and his own views the merchant of the Middle Ages created the Law Merchant."[18] The law did little more than echo the existing sentiments of the merchant community.

The medieval European environment was in many ways ideally suited to this universalization of merchant practice into a uniform system of trade law. Europe was geographically charted. Merchants could readily traverse vast areas of the Mediterranean Sea to well-established markets and fairs,[19] where the traders of Europe and North Africa gathered to exchange goods. Local rulers, princes and kings supported this growth of cosmopolitan meeting places because the trade produced local revenues in the form of taxes, levies, transportation costs and employment. Local commercial courts were therefore required, not to impede trade, but rather ". . . to give courage to merchant strangers to come with their wares and merchandise into the realm."[20] Merchants themselves found the transacting profitable, since no individual region could remain insulated from the attraction of staple commodities and novelty items emanating from distant marketplaces. Mutuality of need among communities also fostered this free trade. Supply and demand were conveniently satisfied in an unfettered exchange of goods and services.[21] The success of the concept of freedom among merchants lay in the community enjoyment which could readily be achieved by the growth of a pliable merchant regime, uninhibited by an aloof system of peremptory law.

A utilitarian ideal in the form of maximum benefit to all—princes, merchants and consumers alike—offered the Law Merchant its most solid foundation.[22] The legal entrenchment of mercantility advanced the interests of the political machinery. A mercantile system of controls promoted the profit goals of the merchants themselves and also satisfied the desires of European communities for commodities.

The form of the Law Merchant understandably encompassed a number of basic elements. As a general rule "merchant law" embodied a respect for "merchant" practice as a primary source of regulation and the