The Law Merchant and International Trade

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Is the State necessary for flourishing international trade? Conventional wisdom thinks so. According to that wisdom, private international commerce would wither without intergovernmental treaties, State courts dealing with international affairs, and State-crafted legal practices for international merchants. Some commentators have gone so far as to suggest that a world legal system is needed to ensure the continual growth of international commerce.

Superficially, at least, the idea that State involvement might be indispensable for international trade seems sensible. Without it, how could merchants from different legal systems—not to mention cultures, languages, and religions—make binding contracts, providing the security they need to trade with persons beyond their nations' borders? Without a world court for private international commercial agreements, what law would take precedence in commercial disputes? Which nation's courts would handle merchants' disagreements? And how could merchants secure a fair hearing in the courts of their adversaries? Without a supranational legal system, or at least national governments' cooperation, these and myriad other potential problems stemming from commercial conflicts between parties from different countries would seem insurmountable.

Yet private parties have surmounted these problems—without government. International trade first took off under a private international legal system called the *lex mercatoria*, or Law Merchant. It continues to thrive under private legal arrangements today.

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In the eleventh century Europeans discovered agricultural improvements that could sustain a larger population. The growing population increasingly migrated to urban areas. In these cities a new class of merchants was born. Merchants across Europe were separated by language, distance, and local law. To facilitate trade, they needed a common set of commercial rules. Out of that need the Law Merchant was born.

The Law Merchant was a purely informal body of law. It developed out of merchants' international commercial customs and shared legal notions. Roman law (the *ius gentium*) provided many of these notions, which merchants modified to meet their special needs, as Bruce L. Benson pointed out in "The Spontaneous Evolution of Commercial Law" (*Southern Economic Journal*, 1989.)

In its early days the Law Merchant relied entirely on private adjudication and enforcement. Merchants conducted much of early international trade at fairs throughout Europe. At these fairs local authorities performed regular activities, such as preventing violence, but they didn't normally adjudicate disputes between international traders.

Nor did authorities enforce the terms of private commercial contracts. International merchants formed their own courts for this purpose and applied their own law to these cases. Merchants' courts came to be called "dusty feet courts" because of the condition of mer-

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chants' shoes as they busily traveled between commercial fairs. In these courts merchants acted as judges, deciding the disputes of fellow traders on the basis of shared customs. Merchant courts enforced their decisions privately by threatening noncompliant traders with a loss of reputation and merchant-community ostracism.

Advantages of the *Lex Mercatoria*

Medieval international merchants used the *lex mercatoria*'s private system of international commercial governance instead of government for several reasons. First, they desired speedy dispute resolution. Disrupting business to resolve contractual disagreements was costly. The Law Merchant minimized costs by eschewing the formality of State court proceedings. Merchant courts' flexible rules of evidence, "[o]ral proceedings, informal testimony of witnesses and unwritten judicial decision-making" hastened the judicial process for time-pressed international traders, according to Leon Trakman's *The Law Merchant: The Evolution of Commercial Law*.

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The Law Merchant further reduced the time required to resolve disputes by simplifying the process of international trade, limiting the kinds of conflicts that might require resolution. For example, the system dispensed with agents' need to obtain formal authorization from their principals to conduct trade with third parties, entirely eliminating a large source of potential trade-related disputes. The Law Merchant also dispensed with the need for official notarization to transfer debts between parties. This reduced the cost of international commercial transactions and precluded another important locus of potential contractual conflict.

Second, merchants used the Law Merchant's private governance system because it provided neutral third-party dispute resolution. Using one disputant's State court would've been undesirable from the other disputant's perspective. Traders would've quite reasonably feared "home-court bias" from foreign judges. By taking dispute resolution out of either disputant's home court, the Law Merchant secured international traders against this concern.

Third, unlike State courts, which were operated by bureaucrats, the Law Merchant's courts were operated predominantly by merchants themselves. This was a great benefit to international traders. Who could better understand the intricacies of international commercial contracts, correctly detect fault, and assign reasonable remedies than other merchants? International merchants demanded adjudicators with expertise in the questions before them. Merchant courts—run by and for the benefit of merchants—satisfied that demand.

Fourth, the Law Merchant's private, spontaneously evolved status permitted it to adapt rapidly to the environment of growing international trade and thus to merchants' rapidly evolving legal needs. "Strict rules lacked the flexibility to vary in response to the peculiarities of the merchants, to their trade background and to their form of bargaining," Trakman wrote. The *lex mercatoria*'s informal rules didn't. Merchants needed a common legal system that transcended local languages, cultures, and variances in national laws. But they also needed a system that could vary according to merchants' regional needs and requirements in specific types of trade. The Law Merchant satisfied both needs at once.

Shortcomings of Government Systems

Merchants couldn't rely on government legal systems for this purpose. Eleventh- and twelfth-century governments weren't normally willing to adjudicate commercial agreements forged in foreign nations. Even if they had been, it's hard to see how medieval merchants could have used State courts to adjudicate their disputes. Governments of this era often didn't honor contracts that involved interest payments. This posed a significant problem for international merchants since they used credit agreements extensively. Common-law courts of the time didn't even permit books of account as evidence in commercial disputes. This also posed a major problem for international merchants since they relied heavily on such accounts. Fur-

ther, the scope of national governments' authority in the eleventh and twelfth centuries was extremely limited. Rulers couldn't yet reach individuals outside territory they directly controlled. Thus their ability to enforce State-court-rendered decisions was nearly nonexistent.

The Law Merchant was indispensable to the Commercial Revolution. Besides providing rules for international commerce, it gave birth to negotiable credit instruments, such as promissory notes and bills of exchange, which are critical to modern trade. Before the twelfth century these credit devices didn't exist. It's no exaggeration to say the Law Merchant played a critical role in pulling Europe into the modern world.

Contemporary Role

Contemporary international trade continues to rely heavily on the Law Merchant to govern private international commerce. A similar body of international legal customs—the successor to the private legal rules of the medieval *lex mercatoria*—provides the basis for contemporary international dispute resolution. In place of medieval merchants' "dusty feet courts," modern international traders' disputes are resolved by arbitrators who work for private associations such as the International Chamber of Commerce's (ICC) International Court of Arbitration.

> Contemporary international trade relies on private arbitration to "delocalize" dispute resolution.

Nearly all modern international commercial contracts contain clauses specifying appeal to such associations in the event of contractual disagreements. In addition to selecting an arbitration forum, modern international traders select the law they want the association to apply to their case, which can range from any country's national law to international commercial custom. International traders may even select the identity of the particular arbitrators who will hear their case.

These associations emerged as a market response to the demands of contemporary international traders who see State courts as inferior forums of dispute resolution. The ability of contemporary international traders to rely on State courts to adjudicate conflicts confronts problems similar to the ones their medieval predecessors confronted. National courts' refusal to adjudicate international commercial contracts is an example. Enforceability of State court decisions is also a significant obstacle: If a Korean court declares that a Canadian citizen owes his Korean trading partner money, how can it seize the Canadian's assets in Canada for payment? Like the medieval merchant courts that preceded them, private international arbitration associations overcome these problems by "delocalizing" dispute resolution.

Also like their medieval predecessors, modern international traders rely predominantly on private means to enforce arbitration decisions. As private organizations, international arbitration associations don't have formal authority to enforce their decisions. They can't seize noncompliant traders' assets or put such traders in jail. But this doesn't prevent their decisions from being enforced. The community of international traders uses the threat of destroyed reputation and the associated loss of business to encourage losing parties to comply with arbitration decisions. This threat is highly effective. The ICC, the world's largest international arbitration association, estimates that traders voluntarily comply with its decisions 90 percent of the time, according to Jan Paulsson, W. Laurence Craig, and William W. Park in *International Chamber of Commerce Arbitration*.

Shadows and the State

There's at least one potentially important difference between the enforcement environment that medieval international traders faced and the one that modern international traders face, however. Since 1958 compliance with many arbitration decisions occurs under potential threat of State enforcement. In that year a handful of countries signed a multinational treaty called the United Nations New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (NYC). Over the last half-century many other countries have also joined the NYC. According to the

convention, signatories agree to enforce international arbitral awards brought to their courts.

This has led some to claim that supposedly private international commercial enforcement takes place in the "shadow of the State." According to this view, government, not private effort, is ultimately responsible for the incredible success of modern international trade.

Yet there are reasons to be skeptical of this view. In a 2008 study Leeson empirically investigated the NYC's effect on international trade and found that its impact has been economically modest. Trade between merchants in countries that are NYC signatories—the potential beneficiaries of ostensible State enforcement—is higher than trade between merchants in countries that aren't signatories, but State enforcement seems to be a weaker influence on international commerce than other determinants. Leeson's results suggest that private means, rather than the specter of the government, are responsible for most of modern international trade's growth and success.

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A still more important problem for the "shadow of the State" view is that, like all multinational treaties, the NYC derives its "force" exclusively from the promises of the countries that have signed it. There's no supranational organization with formal authority to compel compliance if signatories choose otherwise. What, then, enforces the NYC? The same private mechanisms that enforced merchant-court decisions under the medieval *lex mercatoria* and enforce most private international arbitration association decisions today: the threat of lost reputation and boycott—only between national governments. If the NYC really does provide significant enforcement of private international commercial agreements, this enforcement has its source not in the formal force of government but in the informal force of private punishment.

Multinational treaties such as the NYC may help remove international traders from the state of "anarchy" they find themselves in, but they don't help remove the governments that supposedly give the NYC power from the state of "anarchy" they exist in. The absence of a formal supranational sovereign—a world government—means that international treaties between governments are always forged and enforced (or not enforced) in a state of "international anarchy" (meaning statelessness not chaos). Thus rather than seeing private enforcement as functioning only in the "shadow of the State" provided by the NYC, it's more appropriate to see the NYC as functioning in the "shadow of private enforcement" provided by the very mechanisms that support international trade.

The popular wisdom that flourishing international trade requires government may be popular, but it's also wrong. We have the Law Merchant to thank for the incredible wealth that commerce has created. Today, international trade accounts for nearly one-third of world GDP—some $6 trillion in 2008. That's an astonishing volume—produced predominantly on the basis of private order. FEE