

ONE MORE TIME WITH FEELING: THE LAW MERCHANT, ARBITRATION, AND INTERNATIONAL TRADE

Peter T. Leeson
Department of Economics
West Virginia University

Abstract

I respond to the three most common objections to depictions of international trade as a formally ungoverned arena of economic significance: 1. International trade was small until quite recently, suggesting the unimportance of the medieval Law Merchant. 2. Private arbitration always takes place in the “shadow of the state.” Historically, international commercial contracts were enforced by various state courts, and today private arbitral decisions are formally enforced by national governments. 3. The lex mercatoria is a “myth.” The Law Merchant plays a non-existent, if not, minimal role in modern international commercial dispute resolution. The evidence contradicts each of these claims.

Abstract

I respond to the three most common objections to depictions of international trade as a formally ungoverned arena of economic significance: 1. International trade was small until quite recently, suggesting the unimportance of the medieval Law Merchant. 2. Private arbitration always takes place in the “shadow of the state.” Historically, international commercial contracts were enforced by various state courts, and today private arbitral decisions are formally enforced by national governments. 3. The lex mercatoria is a “myth.” The Law Merchant plays a non-existent, if not, minimal role in modern international commercial dispute resolution. The evidence contradicts each of these claims.

“It takes varied reiterations to force alien concepts upon reluctant minds.”

—Herbert Spencer

I. INTRODUCTION

A small but vocal camp of critics denies that international trade was and is a privately governed arena of economic significance (see, for instance, S. Shenoy, “Globalisation and the Law”). According to them, international trade was and is no more “stateless” than domestic trade. These critics dispute analyses, such as my own, that depict international trade as the result of private institutions rather than the providence of governments. Their most common objections are as follows:

1. International trade was small until quite recently, suggesting the unimportance of the medieval Law Merchant.
2. Private arbitration always takes place in the “shadow of the state.” Historically, international commercial contracts were enforced by various state courts, and today private arbitral decisions are formally enforced by national governments.
3. The *lex mercatoria* is a “myth.” The Law Merchant plays a non-existent, if not minimal role in modern international commercial dispute resolution.

My goal here is to set the record straight regarding these accusations in as short a space as possible. Fortunately, since they are so wildly at odds with reality, only a bit of evidence is required to show they are wrong. My arguments are not new. Except for the handful of Law Merchant deniers, they are well acknowledged by both economic and legal scholars, and have been documented in numerous other places (see, for instance, Benson 1989; Berman 1983; de Roover 1963; Greif et al 1994; Jones 1960; Leeson 2006; Lopez 1976; Milgrom et al 1990; Trakman 1983).

II. THE IMPORTANCE OF PRE-MODERN INTERNATIONAL TRADE

After the Roman Empire fell, commercial activity in Europe came to a standstill. Agricultural improvements in the 11th century, however, led to increased agricultural production, which in turn sustained a larger population. The growing population increasingly migrated to urban areas. In these cities a new class of merchants was born.

Merchants throughout Europe were separated by language, distance, and local law. To facilitate trade and interaction a common set of commercial “rules” was needed. Out of this need emerged what has subsequently been termed the *lex mercatoria*, or Law Merchant. At its beginning 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.

These rules were privately established, adjudicated, and enforced (for more on this, see below). In the 11th century there were no state-made laws that governed the activities of international commerce. This is a significant reason why the Law Merchant developed in the first place.

Had it not been for the private evolution of the Law Merchant, mankind may have very well remained trapped in the Dark Ages. The Law Merchant was indispensable to the Commercial Revolution, which would have been impossible without the *lex mercatoria*’s development. In addition to providing rules for international commerce, the Law Merchant gave birth to negotiable credit instruments, such as promissory notes and bills of exchange, which are critical to modern trade. Before the 12th century these credit devices were non-existent.

As Law Merchant naysayers are fond of pointing out, in the last century or so international trade skyrocketed. Traders from the United States were relatively late entrants to

this commerce. The general irrelevance of both these facts for the importance of pre-modern European exchange requires little comment. It certainly does not follow from them that until the 19th century international trade or the Law Merchant was unimportant. On the contrary, medieval international commerce, made possible by the Law Merchant, was the impetus for the Western world's promotion from subsistence to an exchange economy.

III. ARBITRATION AND THE SHADOW OF THE STATE

When the Law Merchant first emerged it relied entirely on private adjudication and enforcement for its "force." A great deal of early international trade occurred at various fairs sponsored by "governments" throughout Europe. At these fairs local authorities performed regular activities, such as preventing violence. They did not, however, typically adjudicate disputes between international traders. Nor did they (or could they) formally enforce the privately agreed upon terms of commercial contracts that trading parties entered into.

International merchants formed their own courts for this purpose and applied their own law to these cases. They privately enforced their decisions through multilateral boycott. In the 11th and 12th centuries governments would not adjudicate commercial agreements forged in foreign nations. Appealing to state courts was not an option. Additionally, governments of this era legally prohibited usury. They did not honor contracts that involved interest payments. This was a significant problem for international merchants who extensively used credit agreements. Common-law courts of the time did not even permit books of account as evidence in commercial disputes. This was also a serious issue for international merchants who relied heavily on such accounts. Additionally, the span of governments' authority during this period was extremely limited. Rulers did not yet have the ability to reach individuals outside territory they directly

controlled. Thus, formally enforcing commercial agreements that contained time elements (e.g., credit arrangements or simultaneous trades in which quality could only be determined *ex post*) was not an option. State enforcement of early international trade was therefore not only undesirable from traders' perspective; in most cases it was not possible.

In the 13th century, in places like Champagne, counts did sometimes supply protection to foreign merchants at their fairs, offer "official" courts, and pronounce ostracism for merchants who behaved dishonestly. But it is mistaken to conclude from this that government adjudicated and enforced commerce at these fairs. In the first place, Champagne was not even absorbed into the royal domain until nearly the 14th century. Until this point it was as much a private fairgrounds leaser as a government. Second, although local wardens eventually offered traders "official" courts (early on only merchant courts existed), traders overwhelmingly used private merchant courts instead. The Count of Champagne explicitly exempted merchants from the jurisdiction of local authorities and granted them the right to form their own courts (Mitchell 1904). The law applied in these courts was merchants' own private law, not royal law. Third, a count's declaration officially ostracizing dishonest merchants had no formal force. The count could try and prevent the merchant from returning to the fair. But community ostracism was only binding if the members of the merchant community voluntarily agreed to the boycott.

By the 14th century many European governments had codified (or begun codifying) customary commercial laws developed under the Law Merchant and absorbed them into the realm of law they enforced. This made state courts a potential venue of international commercial dispute resolution. For the most part, however, merchants continued to rely upon their own courts.

Until the 17th century merchant courts competed openly with various government courts for the adjudication of commercial disputes. In 1606 in England, Edward Coke issued a pronouncement that made merchant court decisions reversible in state courts. This significantly undermined the authority of private commercial courts and led to their virtual disappearance in England in the 17th century.

In the 20th century private international arbitration associations sprung up. Arbitration associations operate much like the medieval merchant courts discussed above. These organizations emerged in response to the demands of international traders who viewed state courts as inferior mechanisms of dispute resolution. State courts posed a number of practical problems for resolving international commercial disagreements. Competing jurisdictional claims between states was one issue. The refusal of some nations' courts to adjudicate international commercial contracts was another.

Enforceability of state court decisions was also a major problem. If a Chinese court declared that an Italian owed his Chinese trading partner money, how could it seize the Italian's assets for payment, which were located in Italy? This was an even greater problem if some other state court, one unconnected to either trading party, rendered the decision. Some nations' domestic laws contain provisions regarding recognition of foreign court decisions. Ultimately, however, the application of these provisions is a matter of discretion. Needless to say, governments have little interest in enforcing foreign-made sanctions against their own citizens.

International merchants also desired faster, friendlier, and more "delocalized" dispute resolution than state courts could provide. The latter is important because traders do not like having contractual disputes adjudicated according to unknown laws, unknown procedures, and

conducted in unknown languages. Traders also fear a potential “home court bias” if their disagreement winds up before a state court in their adversary’s nation.

Private international arbitration associations overcome these problems, so traders patronize them instead of state courts to resolve disputes. As one leading international practitioner put it, “in today’s world the dispute resolution mechanism will invariably be arbitration” (Aksen 1990, p. 287). Nearly all international commercial contracts identify private arbitration as the mechanism for dispute resolution.

In 1958 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). According to the NYC, signatories agree to enforce international arbitral awards brought to them for enforcement. Following the NYC, several much smaller but similar agreements were also formed for this purpose. These include the EU Convention (2003), the Panama Convention (1975), the Brussels/Lugano Convention (1968), and the UN Convention on the Carriage of Goods by Sea (1978). Virtually all countries covered in these agreements are also covered by the NYC, which remains the most significant multinational agreement to this effect.

In principle these treaties make private arbitral decisions enforceable in state courts. On this basis Law Merchant deniers contend that government, not the Law Merchant, is responsible for modern international trade’s success. But they are wrong again. The reality of these treaties suggests just the opposite.

First, prior to 1958, private international arbitration decisions were not enforceable in state courts under any multinational treaty. How then is state enforcement responsible for the observed increase in international trade between the 1900 and 1958? Second, a number of countries have not signed the NYC or any other such agreement that obligates them to enforce

international arbitral awards. Third, the ICC estimates that traders voluntarily comply with its private arbitral decisions 90 percent of the time (Craig et al 2000). Treaties or no treaties, in practice state enforcement plays virtually no role in enforcing international arbitral awards. Fourth, in recent work I estimate the effect of the NYC and other treaties with the same end on international trade and find that that their impact is economically weak (Leeson 2006). Finally, like all multinational treaties, the NYC derives its only “force” from the promises of the countries that have signed it. There is no supranational organization with formal authority to compel compliance if signatories choose otherwise.¹ The UN does not invade countries that do not live up to their agreements under the NYC. Ultimately, the NYC relies on private, informal mechanisms, such as reputation and boycott—just like medieval merchant courts did—to ensure that its terms are complied with.

IV. IS THE LAW MERCHANT A MYTH?

Contradicted by the evidence, Law Merchant naysayers are prone to one final act of disputation, which entails denying the existence of the Law Merchant altogether. This argument takes a number of forms. One of the most popular involves pointing out that the Law Merchant is rarely cited by international arbitration associations in rendering decisions.

A substantial benefit of private arbitration forums is their flexibility in allowing traders to select the law that applies to their disagreements. Many times, parties choose the commercial law of a particular nation because they believe it is best suited to their case. Rarely do they explicitly request the Law Merchant be applied. But this is hardly grounds for asserting the non-existence or unimportance of the Law Merchant.

¹ In fact, the terms of the NYC itself make several provisions for non-compliance left up to the discretion of signatory nations.

The Law Merchant is customary law. It derives its legitimacy from the customs of international traders. Like all customary “rules,” it is rare to cite this set explicitly. Members of the international commercial community share an implicit understanding of these principles and form expectations on their basis. This, after all, is what “customary” means.

It is a custom in the United States to shake someone’s hand upon meeting them for the first time. Rarely, however, does one vocally prompt the employment of this custom. This doesn’t mean that hand shaking is not widely expected and used to greet strangers. Neither is it evidence that hand shaking is not a not a custom or “does not exist.” Hand shaking’s customary status is precisely why vocal prompting is not normally necessary to produce its application. So it is with the Law Merchant.

A stronger and more ridiculous variant of the Law Merchant-as-myth argument involves denying that there ever was such as thing as the medieval Law Merchant that governed international trade or that there is such a thing today. The absurdity of this claim is evidenced by the fact that simply typing the words “Law Merchant” or “*lex mercatoria*” into virtually any library’s keyword search engine immediately yields numerous results. Either a great many researchers have done an excellent job at fleecing their publishers and readers for decades by publishing fiction parading as history, or the Law Merchant deniers are wrong. I leave this determination to the reader’s judgment.

For my own part I will only to point out that in October 16-17, 2003 I participated in a seminar entitled, “The Empirical and Theoretical Underpinnings of the Law Merchant,” at the University of Chicago Law School. This conference included leading legal scholars and legal historians (and a few economists) from around the world. I might have imagined this conference. Alternatively we might have congregated to discuss a mythical beast, like the unicorn. A third

possibility is that this event investigated an actual historical and contemporary phenomenon.²
Again, I will let the reader's judgment guide him here.

V. CONCLUDING REMARKS

This concludes my explanation of why no reasonable person denies that international trade was and is a privately governed arena of tremendous economic importance. I expect the usual response from the opposing camp: general inaccuracies punctuated by excited claims of historical authority. Disagreement, however, is the life blood of knowledge's advance. So forward we march.

² While there was considerable debate about various historical and contemporary issues surrounding the law merchant, no one, to my recollection, denied its existence.

REFERENCES

- Aksen, G. (1990), "Arbitration and Other Means of Dispute Settlement," in D. Goldsweig and R. Cummings, eds., *International Joint Ventures: A Practical Approach to Working with Foreign Investors in the U.S. and Abroad*, American Bar Association, Chicago.
- Benson, B. (1989), "The Spontaneous Evolution of Commercial Law," *Southern Economic Journal*, Vol. 55, No. 3, 644-661.
- Berman, H. (1983), *Law and Revolution: The Formation of the Western Legal Tradition*, Harvard University Press, Cambridge.
- Craig, W., W. Park, and I. Paulsson (2000), *International Chamber of Commerce Arbitration*, Oceana Publications, New York.
- de Roover, R. (1963), "The Organization of Trade," in M. Postan, E. Rich, and E. Miller eds., *Cambridge Economic History of Europe, Vol. 3: Economic Organization and Policies in the Middle Ages*, Cambridge University Press, Cambridge.
- Greif, A., P. Milgrom, and B. Weingast (1994), "Coordination, Commitment, and Enforcement: The Case of the Merchant Guild," *Journal of Political Economy*, Vol. 102, No. 4, 745-776.
- Jones, W. (1960), *The Settlement of Mercantile Disputes by Merchants: An Approach to the History of Commercial Law*, S.J.D. Dissertation, University of Chicago Law School.
- Leeson, P. (2006), "How Important is State Enforcement for Trade," *West Virginia University, Working Paper*.
- Lopez, R. (1976), *The Commercial Revolution of the Middle Ages, 950-1350*, Cambridge University Press, Cambridge.
- Milgrom, P., D. North, and B. Weingast (1990), "The Role of Institutions in the Revival of

Trade: The Law Merchant, Private Judges, and the Champagne Fairs,” *Economics and Politics*, Vol. 2, No. 1, 1-23.

Mitchell, W. (1904), *Essay on the Early History of the Law Merchant*, Burt Franklin, New York.

Trakman, L. (1983), *The Law Merchant: The Evolution of Commercial Law*, Fred B. Rothman and Co., Littleton.