

NORM EVOLUTION WITHOUT THE STATE: AN EXAMINATION OF  
THE UNIQUE NATURE OF COMMERCIAL LAW

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## ABSTRACT

The discussion examines the idea that because of its relatively unique nature, commercial law has the distinct ability to evolve and function in the absence of a central coercive authority. While law of a non-commercial nature generally requires the backing of a state through which to derive its efficacy, a great deal of commercial law as it exists today evolves often in the absence of a single coercive authority, shaped largely by market forces outside the purview of any one state power. To this end, we look primarily at transnational commercial law, specifically at what is commonly understood as the new law merchant.

It is the central contention of this paper that commercial law stands apart from other forms of law in that it is uniquely equipped to generate norms in situations where a single legislative power is notably not present, as it is largely impacted by the choices and behaviour of individual economic actors. We examine the notion that the manner of interaction implied by commercial intercourse involves a higher degree of overall engagement. This we term 'high engagement', which we divide into two elements: repetition and game creation, which with reciprocity, works in tandem to produce identifiable legal norms and the subsequent compliance with them.

In Part I, after presenting a brief overview of the idea of reciprocity and spontaneous law theory, a more detailed explanation of the notion of engagement is offered. In Part II, we set out exactly how high engagement facilitates the development of and compliance with legal norms. Finally, the conclusion this paper reaches is that this element of high engagement, a salient characteristic of commercial interaction, plays a decisive role in the ability of commercial law to evolve and function in the vacuum of a central legislative authority.

# TABLE OF CONTENTS

|  |            |
|--|------------|
| <b>Abstract</b> .....  | <b>i</b>   |
| <b>Table of Contents</b> .....   | <b>iii</b> |
| <b>Acknowledgements</b> .....  | <b>v</b>   |
| <b>1 Introduction</b> .....  | <b>1</b>   |
| 1.1 Reciprocity Induces Compliance .....   | 4          |
| 1.2 The Element of High Engagement.....  | 5          |
| 1.3 Social Norms .....   | 9          |
| <b>Part I: Commercial Law as a Self-regulating System: Reciprocity, Spontaneous Law, and High Engagement</b> ..... | <b>11</b>  |
| <b>2 The Element of Reciprocity</b> .....  | <b>14</b>  |
| 2.1 The Importance of Reciprocity in the Absence of External Coercion .....  | 15         |
| 2.2 Reciprocal Gain and Self-interest as the Root of all Law .....   | 18         |
| 2.3 The Uniqueness of Commercial Law .....   | 22         |
| 2.4 Reciprocity as a Distinguishing Property of Spontaneous Commercial Order.....                                  | 23         |
| 2.5 Contractual Ordering, Customary Law, and Reciprocity .....   | 24         |
| <b>3 Commercial Law as an Instrument of the Market</b> .....   | <b>29</b>  |
| 3.1 Fuller’s Horizontal Law and Hayek’s Order of Actions .....   | 29         |
| 3.2 Early traces of Spontaneous Law Theory.....  | 31         |
| 3.3 Menger, Hayek and the Austrian School of Economics.....  | 33         |
| 3.4 Understanding Commercial law as an invisible hand .....  | 35         |
| 3.5 Spontaneous Legal Evolution and the Law Merchant.....  | 37         |
| 3.5.1 The Law Merchant as a Creation of the Market .....   | 37         |
| 3.5.2 The Law Merchant Reinforced Business .....   | 39         |
| 3.5.3 The Law Merchant Sprang from Business Customs.....   | 43         |
| 3.6 The Modern Lex Mercatoria.....   | 45         |
| 3.6.1 The Law Merchant Survived.....   | 45         |
| 3.6.2 The Law Merchant is Transnational in Character.....  | 46         |
| 3.6.3 The Widespread Use of Arbitration.....   | 47         |
| <b>4 Fuller’s Three Conditions Underpinning the Notion of Duty</b> .....   | <b>49</b>  |
| 4.1 Reciprocal Exchange should be Equal in Value .....   | 50         |
| 4.2 Fluidity of Roles: Role Reversibility .....  | 51         |
| 4.3 Condition of Voluntariness Not Necessary .....   | 52         |
| <b>5 The Concept of High Engagement Examined</b> .....   | <b>55</b>  |
| 5.1 Repetition.....  | 56         |
| 5.1.1 Repeat with same Players.....  | 57         |
| 5.1.2 Frequency can Increase.....  | 58         |
| 5.1.3 Seek out new Partners.....   | 58         |
| 5.1.4 More Exposed to Law.....   | 59         |

|  |  |            |
|--|--|------------|
| 5.2  | The Creation of Positive Duties to Act: Cycles of Interaction and Game Creation .....                    | 61         |
| 5.2.1  | Manner of Interaction Allows for Repetition .....  | 61         |
| 5.2.2  | Creation of Positive Duties to Act .....   | 62         |
| 5.2.3  | Arena to Create Law .....  | 65         |
| 5.2.4  | Commercial Trade as Delineated Game: Game Creation.....  | 66         |
| 5.2.5  | Cooperation Strategies and Iterated Games.....   | 71         |
| 5.3  | High Engagement and Opinio juris sive necessitates .....   | 78         |
| <b>Part II: The Element Of High Engagement: Natural Selection, Path Dependency, and the Evolution of Norms .....</b> |  | <b>81</b>  |
| <b>6</b>   | <b>Norm Creation, Repetition and the Natural Selection of Commercial Law.....</b>                        | <b>82</b>  |
| 6.1  | Not of Human Design: Legal Norms as an Aggregate of Individuals Separately Pursuing their Interests..... | 84         |
| 6.2  | Making Law Through Contract: Norm Tweaking .....   | 86         |
| 6.3  | Norm are Reviewed in Situations of Success as well as Failure.....                                       | 87         |
| 6.4  | Law Evolves Towards Efficiency .....   | 89         |
| 6.5  | Competition Breeds efficiency .....  | 90         |
| 6.6  | The Importance of High Engagement: Each Repeated Interaction is a Test-Run....                           | 92         |
| 6.7  | Discrete Cycles of Interaction are Important as Feedback Loops.....                                      | 93         |
| 6.8  | Norm Diffusion.....  | 94         |
| <b>7</b>   | <b>Path dependency of Legal Norms in Commercial Law, Bandwagon and Network effect.....</b>               | <b>97</b>  |
| 7.1  | So what is Network Effect? .....   | 8          |
| 7.2  | Synchronization Value and Language.....  | 101        |
| 7.3  | How Network Externalities Apply: Why Commercial Law is More Like a Telephone than a Ferrari.....         | 103        |
| 7.4  | Standardization and Natural Monopolies .....   | 104        |
| 7.5  | The More people the better: Switching Costs.....   | 106        |
| 7.6  | The More people the better: The Impression of Legitimacy .....   | 108        |
| 7.7  | How High Engagement Precipitates a Network Effect .....  | 109        |
| 7.1.1  | Commerce Enlarges one's Circle of Potential Partners .....   | 110        |
| 7.1.2  | Parties Selecting Law with Each New Interaction are Consumers Purchasing a Product .....                 | 112        |
| <b>8</b>   | <b>Conclusion .....</b>  | <b>115</b> |
| <b>Bibliography.....</b>   |  | <b>118</b> |

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## 1. Introduction

In many respects, commercial law<sup>1</sup> is a fundamentally unique area of law. Unique, because it reacts to, and is a reflection of, commercial forces constantly at play: a vast body of regulation that is a response to a pre-existing, and deeply entrenched human activity—commerce. Its mechanics are intertwined with a basic human activity that undergirds and flows throughout the development of human society as a whole, possessing features intrinsic to it, not found in any other quarters of law.<sup>2</sup> As such, it is a mistake to simply compartmentalize it as one mere subsection of law, such as family law, criminal law etc.—this is to fundamentally misunderstand its underlying nature.<sup>3</sup> In

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<sup>1</sup> What is meant here is commercial law in its most basic sense: *the formation of contract between parties and the exchange of property*—the purest form of this being trade in some sense or another. However, radiating outward from this core starting point, this also should be read as including both the contracts parties themselves draw up, the rules of international arbitration, and even, in its more general sense, the rules of multi-sovereign bodies such as the Organization for Economic Co-operation and Development (OECD) or the World Trade Organization (WTO). In this sense then, the term is inclusive of the most simple, and at the same time, the most complex definitions of what is commonly meant by the term commercial law. However, the discussion that follows is primarily concerned with law that is largely the product of choices and behaviour of economic actors, which evolves in the absence of a definite authority. To this end, law in an international context is of particular interest, and serves as the focal point of the present discussion. Thus, we are here concerned chiefly with what can be called transnational commercial law. Roy Goode defines this body of law thusly: "... 'transnational commercial law' is conceived as law which is not particular to or the product of any one legal system but represents a convergence of rules drawn from several legal systems or even, in the view of its more expansive exponents, a collection of rules which are entirely anational and have their force by virtue of *international usage and its observance by the merchant community* [italics my own]. In other words, it is the *rules*, not merely the actions or events, that cross national boundaries... the phrase 'transnational commercial law' is used to describe the totality of principles and rules, whether customary, conventional, contractual or derived from any other source, which are common to a number of legal systems..." (Jacob S. Ziegel, *New Developments in International Commercial and Consumer Law: Proceedings of the 8<sup>th</sup> Biennial Conference of the International Academy of Commercial and Consumer Law* (Oxford, Hart Publishing, 1998) at 4.) This definition is the one we adopt in this discussion, and it includes uncodified customs and usages, standard form contracts and reported arbitral awards, and in some measure, even codifications of customs and usages by international organizations. Nevertheless, by and large, the focus here is upon what is commonly understood as the modern *lex mercatoria*, and specifically to areas of law that relate to jurisdictions where commercial law is predominantly private (such as can be found in common law jurisdictions), and where public law is not the dominant mode of commercial transactions, as it is in these venues that the choices of individual actors are in a position to exert an influence upon the law.

<sup>2</sup> As one prominent scholar puts it: "Society is substantially an economic social pattern stabilized by legal principles. Economics weaves its way into all facets of society, dragging along with it the relevant legal concepts." Ronald Charles Wolf. *Trade, Aid, and Arbitrate: The Globalization of Western Law* (Burlington: Ashgate Publishing Company, 1988) at vii. [Wolf].

<sup>3</sup> It is telling that throughout *The Morality of Law*, Fuller's illustrations of the coordinating effects of law are entirely drawn from the commercial realm: the law of quasi-contract, the law of contract, and Tort law.

contrast to other forms of law, commercial law is an evolving system grounded upon an entirely different paradigm of human interaction, one inextricably linked to commercial principles such as exchange, competition and profit.<sup>4</sup> As such, the manner in which parties relate to one another under this form of law is wholly unique.

The analysis which follows will suggest that because of this unique nature, commercial law has the distinct ability to evolve and function in the absence of a central coercive authority. While law of a non-commercial nature generally requires the backing of a state through which to derive its efficacy, a great deal of commercial law as it exists today evolves often in the absence of a single coercive authority, shaped largely by market forces outside the purview of any one state power.<sup>5</sup> Non-commercial law, as a consequence of its nature, simply lacks the dynamic to evolve in this fashion. It is the central contention of this paper that commercial law stands apart from other forms of law in that, for reasons we go into, it is uniquely equipped to evolve in situations where a single legislative power is notably not present;<sup>6</sup> its basic nature allows it to develop in the vacuum of external enforcement. Why this is so is complex and is the focus of the following examination, but in short, it is because commercial law implies a specific manner of interaction, for which, for lack of a more impressive term, I refer to here as

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See Lon L. Fuller, *The Morality of Law*. Revised edition (New Haven and London: Yale University Press, 1969) esp. at chp. 1. [Fuller, *The Morality of Law*]

<sup>4</sup> See Benson, "Commerce is an evolving process of interaction and reciprocity which is simultaneously facilitated by and leads to an evolving system of commercial law." B.L. Benson, "The Spontaneous Evolution of Commercial Law" (1989) 55 Southern Economic Journal. 644 at 644.

<sup>5</sup> See generally B.L. Benson, "The Spontaneous Evolution of Commercial Law" (1989) 55 Southern Economic Journal. 644 [Benson, "The Spontaneous Evolution of Commercial Law"].

<sup>6</sup> See particularly Benson. Benson looks at the emergence the Law Merchant in medieval Europe, concluding that "...nation-states are not a prerequisite for law...the merchant community's "enterprise" of accomplishing the subjection of commercial conduct to control naturally generated mechanisms for recognition, adjudication, and change." Benson, "The Spontaneous Evolution of Commercial Law", *supra* note 5 at 646. See also his *The Enterprise of Law* for a theoretical and historical discussion of this phenomenon. Bruce L. Benson, *The Enterprise of Law*. (San Francisco: Pacific Research Institute, 1990) [Benson, *The Enterprise of Law*].

“high engagement.” This notion of high engagement, and its effects, is the subject of the present discussion. To this end, we look primarily at transnational commercial law, specifically at what is commonly understood as the new law merchant.

Many have contributed to the idea of spontaneous law, most notably in its most recent incarnations, the work of Hayek, and to some degree, Fuller.<sup>7</sup> B. L. Benson builds on the ideas of both Fuller and Hayek, postulating that commercial law may evolve and function largely in the absence of the state.<sup>8</sup> Benson argues, “...while law can be imposed from above by some powerful authority, like a king, a legislature, or a supreme court, law can also develop ‘from the ground’, as a result of a recognition of mutual benefits, through exchanged agreements (explicit or implicit contracts) to obey and participate in the enforcement of such law.”<sup>9</sup> Or as Robert Cooter phrases it, “Rather than proceeding from the top to bottom, lawmaking can proceed from bottom to top.”<sup>10</sup> Hayek suggests that this decentralized spontaneous legal order evolves slowly over time as a by-product of participant’s active engagement in it, independent from the need to rely on any one central authority to either establish or enforce its rules.<sup>11</sup> Benson, builds on this idea and

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<sup>7</sup> See particularly, Fuller, *The Morality of Law*, *supra* note 3; F.A. Hayek, *Law, Legislation, and Liberty* Vol. 1. (Chicago: University of Chicago Press, 1973) [Hayek, *Law, Legislation, and Liberty*]

<sup>8</sup> See Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 644, as well as Bruce L. Benson, “Customary Law with Private Means of Resolving Disputes and Dispensing Justice: A Description of a Modern System of Law and Order without State Coercion” (1990) 9 *Journal of Libertarian Studies*. 25; Benson, Bruce L.. “Enforcement of Private Property Rights in Primitive Societies: Law without Government” (1989) 9 *Journal of Libertarian Studies*. 1; Bruce L, Benson, “Reciprocal Exchange as the Basis for Recognition of Law: Examples from American History” (1991) 10 *Journal of Libertarian Studies*. 53 [Benson, “Reciprocal Exchange as the Basis for Recognition of Law: Examples from American History”]; Benson, *The Enterprise of Law*, *supra* note 6.

<sup>9</sup> Benson, “Reciprocal Exchange as the Basis for Recognition of Law: Examples from American History”, *supra* note 8 at 53.

<sup>10</sup> Robert D. Cooter, “Structural Adjudication and the New Law Merchant: A Model of Decentralised Law” (1994) 14 *International Review of Law and Economics*. 215 at 215.

<sup>11</sup> Hayek ‘distinguishes between the “order of actions” and the “order of rules” and suggests that, for given rules, the order of actions is what emerges from the spontaneous process governed by the order of rules. Hayek, *Law, Legislation, and Liberty*, *supra* note 7]. He also argues that the order of rules can emerge spontaneously, just as the order of actions does.” B.L. Benson, “Economic Freedom and the Evolution of Law” (1998) 18 *Cato Journal*. 209 at 209.

argues that “many rules and institutions for governance evolve as the unintended outcomes of individuals separately pursuing their own goals (e.g. customs), just as markets do...”<sup>12</sup> In this sense, while most forms of law are creations of the state, commercial law is, in many respects, the creation of commerce itself, stateless and implicitly trans-regional.<sup>13</sup> The features inherent in commerce, and reflected in commercial law, that allow for this evolution are less pronounced or totally absent in law of a non-commercial nature.

### **1.1 Reciprocity Induces Compliance**

As Benson argues, the reciprocal gains from the recognition of rules of property and contract (and the potential loss of them), serve as self-enforcing mechanisms, encouraging compliance.<sup>14</sup> In this sense, the need for a single external authority to promulgate and enforce a system of rules is not necessarily required. Commercial forces themselves serve as a sort of self-regulating legal structure, with all parties eager to reach consensus. In a system predicated on self-interest, state-backed coercion is not as necessary. Ultimately, this creates a legal phenomenon that is far more amenable to trans-regional legal growth, where a central coercive authority is not present, and thus is less constrained by the limiting influences of political and cultural boundaries. As such, private ordering within the realm of commerce may emerge without the necessity to resort to state-enforced rules. And this in fact is precisely what we find when we turn and

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<sup>12</sup> B.L. Benson, “Economic Freedom and the Evolution of Law” (1998) 18 *Cato Journal*. 209 at 209.

<sup>13</sup> Trakman writes, “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.” Trakman, Leon E. “From the Medieval Law Merchant to E-Merchant Law” (2003) 53 *The University of Toronto Law Journal*. 265 at 3.

<sup>14</sup> See Benson *Spontaneous Evolution of Commercial Law*, “...reciprocal gains from the recognition of rules of property and contract provided sufficient incentives for merchants to establish their own stateless enterprise of law [referring to the medieval Law Merchant].” Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 646.

examine the modern complexion of international commercial law, the *Lex Mercatoria* as it exists today; a central legislative authority is notably absent. Custom together with an aggregation of trans-national treaties has emerged as the principal source of law.<sup>15</sup> This markedly less need for a central legislative power allows for the emergence of a legal structure largely the outcome of market forces that by and large supersede national boundaries.

The basic structure of commerce, with its underlying principle of reciprocity, is itself an authority to which participants answer. Owing to this organic evolution, a system of transnational commercial law has evolved over time even in the vacuum of any single coercive power. This was possible because, unlike other areas of law, the element of reciprocity, implicit in the activity of commerce, allowed it to do so. The “spontaneous law” literature is grounded upon this dynamic of reciprocity. It is central because, as Benson concludes, it is the primary means of inducing compliance in the absence of enforcement.<sup>16</sup> In place of enforcement, it falls upon self-interest to foster a recognition and protection of rights.

## **1.2 The Element of High Engagement**

While this is certainly true, I will argue the literature largely overlooks a secondary, yet vitally important element—an obvious fact peculiar to commercial cooperation; namely,

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<sup>15</sup> Francesco Parisi, “Spontaneous Emergence Of Law: Customary Law” (96<sup>th</sup> Annual Conference Of The American Political Science Association, Washington, D.C., August 31-September 3, 2000), 603 at 603.

<sup>16</sup> B.L. Benson, “Economic Freedom and the Evolution of Law” (1998) 18 *Cato Journal*. 209 at 211. In the “Spontaneous Evolution of Commercial Law” Benson writes, “. . . it becomes clear that reciprocal arrangements are the basic source of the recognition of duty to obey law (and of law enforcement when state coercion does not exist).” Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 646.

what I will call the high level of general ‘engagement’<sup>17</sup> (the manner with which one engages in the activity) that exists in commerce, and how it operates in supporting relation to this basic element of reciprocity. This level of engagement, the manner in which actors in commercial relationships interact, is key in explaining how it is commercial regulation can evolve and function in the absence of a central authority. This level of engagement is simply not present in the same way in non-commercial law.

Between commercial and non-commercial interaction, there is a fundamental difference in the way in which participants interact. Commercial activity stands apart from non-commercial forms of interaction in that participants simply tend to be more regularly engaged in the undertaking. This is important. While this paper accepts the basic premise of spontaneous law theory, the specific thesis I am going to advance in this discussion is that this high level of engagement, which is the mark of commercial trade, reinforces the effects of reciprocity on systems of spontaneous order, accelerating the formation of legal norms by pulling relevant actors into repeated and more involved contact with one another. This element of high engagement is crucial when we try to explain how it is that commercial law can develop in the absence of overarching state enforcement. Increased engagement enhances the impact of reciprocity simply because it increases the overall manner, rate and scope of interaction, and this helps forge customary norms and promote subsequent compliance. Thus, without such a level of engagement, a spontaneous system of commercial law could not evolve. The higher the level of overall engagement, the more likely it is that behavioural norms will spontaneously develop as a consequence and be adhered to. I will argue that this phenomenon of high engagement has two important

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<sup>17</sup> In the remainder of the discussion, the term ‘high engagement’ will be repeatedly used to connote the unique manner of interaction implied by commerce.

components; the first is sheer repetition and repeated contact, the second is a peculiar tendency to foist positive obligations upon participants, creating clear cycles of interaction; in effect, games that may be played, inducing cooperation.<sup>18</sup> As we shall see, these two aspects of commercial interaction play a pivotal role in allowing commercial law to evolve transnationally in the absence of a single state authority.

Commercial activity exhibits a generally far greater degree of engagement than other forms of interaction—a simple observation, but an extremely important one. This characteristic is significant and plays out in a variety of ways. Without the key ingredient of high engagement, it is difficult for norms to develop as a result of reciprocity alone. Thus, the element of reciprocity is crucial to spontaneous social-legal ordering, but high engagement is likewise a core component of the process, as it is this element that amplifies the cooperative-inducing effects of reciprocity. To use an imperfect analogy: if reciprocity is understood as the serrated teeth of a saw, high engagement is like the hewing of that saw; with each quick pass of the blade, a deeper groove of expected behaviour is cut, in due course producing a recognized behavioural convention—a legal norm. Repeated cycles of purposive engagement stimulate the emergence of customary norms and induce compliance. Thus, in this way, the level of engagement, that is to say the frequency and manner in which the players engage in the activity, is decisive when we speak of the emergence of customary law. And commercial activity possesses a uniquely accelerated pace of purposive interaction. While the underlying elements of high engagement and reciprocity predominate in commerce, this is simply not the case in law of a non-commercial nature, where these features are considerably less pronounced, or entirely absent. Because commercial interaction demonstrates such a high level of

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<sup>18</sup> The word ‘game’ is meant here in the sense of game theory.

repeated engagement and a very specific manner of interaction, the effect of reciprocity plays out in a far more pronounced fashion. Ultimately, this is a significant distinction, and one that calls for closer examination.

What follows is a modest step towards such an examination. The following discussion will be divided into two parts. In Part I, after presenting a brief overview of the idea of reciprocity and spontaneous law theory, a more detailed explanation of the notion of engagement is offered. In Part II, we will set out exactly how high engagement facilitates the development of and compliance with legal norms. Here we will attempt to map out the manner in which the aspect of engagement induces the evolution of cooperative systems. The discussion that follows will build on the ideas of mainly Benson, Fuller and Hayek. The examination, for the most part, will employ a largely law and economics approach, utilizing various principles from game theory. In doing so, a general acceptance of the standard assumption of rational choice runs throughout the analysis, namely, that free actors properly comprehending relevant conditions, behave in accordance to what is best for them.<sup>19</sup> As well, issues of public choice theory, although they could very well be brought into the discussion, are set aside; the focus is on actors as individual agents, rather than the influence of competing interest groups in a political context. Finally, the conclusion this paper reaches is that this element of high engagement, a salient characteristic of commercial interaction, plays a decisive role in the

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<sup>19</sup> This assumption, that “man is a rational maximiser of his satisfactions”, underpins the overwhelming majority of the vast body of scholarship within the economic analysis of law that has emerged in the past 40 years. See Harris, J. W.. *Legal Philosophies*. Second Edition (London: Redwood Books, 1997) at 46. For our purposes, this assumption is presupposed throughout the remainder of this discussion.

ability of commercial law to evolve and function in the absence of a central legislative authority.<sup>20</sup>

### 1.3 Social Norms

The discussion that follows will deal largely with the emergence of social norms in the context of commercial interaction. The term in fact spans disciplines, from first year textbooks on anthropology and sociology to the precise theorems of economists. A social norm is typically defined as “customary rules of behaviour that coordinate our interactions with others,”<sup>21</sup> the function of which is to “coordinate people’s expectations in interactions that possess multiple equilibria. Norms govern a wide range of phenomenon, including property rights, contracts bargains, bargains, forms of communication, and concepts of justice.”<sup>22</sup> The term can encompass a broad spectrum of meanings, ranging from which hand to extend in greeting to far more complex rules, such as contract principles of consideration, offer and acceptance. The former is sometimes understood as *conventions* and the latter *norms*.<sup>23</sup> While the term ‘norms’ will be used here in its most inclusive sense, we are primarily concerned with the evolution of far more sophisticated expressions of legal norms, namely, any norm that works to induce

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<sup>20</sup> A word of caution: it is not my contention here that the growth of international commercial law is necessarily a “fair” one. Arguably, many aspects of globalization are not. While many of the ideas regarding law and property presented in this discussion may be seen as espousing a libertarian position, this is not so. Although much of the discussion that follows draws heavily from such concepts as spontaneous market order, the presupposition that such orders are implicitly fair is not assumed here as it is in Libertarianism. In many respects the systems that emerge are not equitable. Rather, the point at issue here is simply that commercial law, as opposed to law of a non-commercial nature, has a unique ability to evolve and function in the absence of a central authority, which partly accounts for the disparity in the rate of convergence demonstrated by commercial and non-commercial law. It is this aspect to commercial law that I will explore. Any value judgments—positive or negative—as to the effects of this phenomenon (because there are many) lie beyond the intended scope of this paper. In the following pages, there is no critique or defence of globalization offered; the sole purpose here is to simply present an academic exploration of this overarching ability to spontaneously evolve as it relates to commercial law, and no more.

<sup>21</sup> H. Peyton Young, *The New Palgrave Dictionary of Economics*, 2nd ed., s.v. “social norms”.

<sup>22</sup> *Ibid.*

<sup>23</sup> *Ibid.*

stable systems of commercial law. This of course includes such practices that have coalesced into codified law but have their origins in custom. Thus, in what follows, it is in this sense that the term 'norm' or 'legal norm' will be used.

## Part I

### Commercial Law As A Self-Regulating System: Reciprocity, Spontaneous Law, and High Engagement

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Legal positivists espouse a distinctly hardened view of law. A legal positivist conception of law – commercial and non-commercial alike – contends that law must be enforced by an overarching authority lest it forfeit all claim to legal validity. In a sense, a legal positivist would argue: if there is no one to enforce the rules, there can be no real rules. This belief is eminently clear in the conclusions of early proponents of legal positivism such as Austin.<sup>24</sup> And indeed, historically, this has been the underlying assumption of the vast majority of economists who have turned their sights on law.<sup>25</sup> However, it should be duly noted, this is, at the end of the day, no more than an assumption. It is just one competing theory. Hayek for one issues a sharp rebuke of this view of law, condemning it as “the fiction that all law is the product of somebody’s will.”<sup>26</sup> Similarly, Fuller rejects

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<sup>24</sup> Austin, a vociferous advocate for the legal positivist position, argues that rules must be backed by the threat of enforcement. Failing this, he contends, there can be no legal obligation: “...to say a person is under a legal obligation to act in a certain way becomes, for Austin, the claim that the person is ‘obnoxious to’ or liable to a sanction (pain) in the event of noncompliance with the wish of the politically sovereign power. The obligatoriness of law, in other words, is an alternative description of the readiness of the sovereign to make its threat of a sanction effective...Austin’s conception is a stark form of legal voluntariness: the exercise of superior force alone accounts for the creation of legal duties. Lon L. Fuller, *The Principles of Social Order: Selected essays of Lon L. Fuller*. Edited by Kenneth I. Winston (Durham: Duke University Press, 1981) at 20. “On this basis [enforcement by a sovereign], so-called ‘customary law’ was to be excluded from the province of jurisprudence, unless it had been adopted as the content of a wish by some state organ. The same was true of public international law and of conventional constitutional law.” Harris, J. W.. *Legal Philosophies*. Second Edition (London: Redwood Books, 1997) at 30.

<sup>25</sup> See Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 644.

<sup>26</sup> Hayek writes, “...such confusions are at the root of the basic conceptions of highly influential schools of thought which have wholly succumbed to the belief that rules or laws must have been invented or explicitly agreed upon by somebody...[and] that all power of making laws must be arbitrary, or that there must always exist an ultimate ‘sovereign’ source of power from which all law derives...This is especially true of that tradition in legal theory which more than any other is proud of having fully escaped from anthropomorphic conceptions, namely legal positivism; for it proves on examination to be entirely based on what we have called the constructivist fallacy...which, in taking literally the expression that man has

the notion that all law must be enforceable by a threat of force through state power, as through a court, asserting that to adopt such a view would be essentially to “define law by an imperfection.”<sup>27</sup> To do so, Fuller points, would imply that our definition of law could not then include any system of regulation that “works so smoothly that there is never any occasion to resort to force or the threat of force to effectuate its norms.”<sup>28</sup> Clearly, the failure of a system cannot serve as its defining characteristic.

Fuller states the issue quite succinctly when he asks, “The question that gives trouble is, How can a person, a family, a tribe, or a nation impose law on itself that will control relations with other persons, families, tribes, or nations? Unlike morality, law cannot be a thing self-imposed; it must proceed from some higher authority.”<sup>29</sup> Fuller concludes this question arises from “the notion that the concept of law involves at the very minimum three elements: a lawgiver and at least two subjects whose relations are put in order by rules imposed on them by the law-making authority.”<sup>30</sup> To be sure, the legal positivist position precludes the possibility that, having removed the law-making authority from the equation, law might still arise from merely the two subjects.

Indeed, systems of commercial regulation are perfectly capable of establishing and enforcing its own laws without the need to resort to state coercion. As Ellickson concludes in his analysis of property rights, “Contrary to Hobbes and Locke, a property

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‘made’ all his culture and institutions, has been driven to the fiction that all law is the product of somebody’s will.” Hayek, *Law, Legislation, and Liberty*, *supra* note 7 at 28.

<sup>27</sup> Lon L. Fuller, *The Principles of Social Order: Selected essays of Lon L. Fuller*. Edited by Kenneth I. Winston (Durham: Duke University Press, 1981) at 221.

<sup>28</sup> Lon L. Fuller, *The Principles of Social Order: Selected essays of Lon L. Fuller*. Edited by Kenneth I. Winston (Durham: Duke University Press, 1981) at 20.

<sup>29</sup> Fuller, *The Morality of Law*, *supra* note 3 at 233.

<sup>30</sup> *Ibid.*

system can get going without an initial conclave.”<sup>31</sup> Elsewhere, Ellickson notes that “in some contexts initial rights might arise from norms generated through decentralized social processes, rather than from law.”<sup>32</sup> Such law is “recognized not because it is backed by the power of some strong individual or institution, but because each individual recognizes the benefits of behaving in accordance with other individual’s expectations, given that others also behave as he expects.”<sup>33</sup>

Unlike law of a non-commercial nature, the underpinning feature of reciprocity, which uniquely characterizes commercial activity, and from which commercial law is constructed and operates, provides a set of mechanics not at all envisioned in the legal positivist’s view of law. And this dynamic, most prominent in commercial activity, allows commercial regulation to arise in an all-together different fashion.

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<sup>31</sup> R.C. Ellickson, “Property in Land” (1993) 102 Yale Law Journal. 1315 at 1366.

<sup>32</sup> R.C. Ellickson, *Order Without Law* (Cambridge, Mass.: Harvard University Press, 1991) at 139.

<sup>33</sup> Benson, “Reciprocal Exchange as the Basis for Recognition of Law: Examples from American History”, *supra* note 8 at 54.

## 2. The Element of Reciprocity

As we have mentioned, reciprocal gains from the recognition of rules of property and contract provide sufficient incentives for law.<sup>34</sup> In a system of spontaneous legal creation and compliance, where there is no external coercion, this element of reciprocity is essential.<sup>35</sup> Benson explains that “[t]he authority which can most effectively back law is individual realization of reciprocal benefits arising from recognition of that law.”<sup>36</sup> Attempting to define reciprocity, Taylor writes, “reciprocity is made up of a series of acts each of which is short-run altruism (benefiting others at a cost to the altruist) but which together typically make every participant better off.”<sup>37</sup> David Hume defined it nicely: “I learn to do service to another, without bearing him any real kindness: because I foresee, that he will return my service, in expectation of another of the same kind...”<sup>38</sup> In the language of game theory, reciprocity can be understood as a basic tit-for-tat strategy. Indeed, in his famous article *The Evolution of Cooperation* Axelrod defines the element of reciprocity precisely in these terms.<sup>39</sup> Reciprocity “involves returning like behaviour with like.”<sup>40</sup> It is a coordination of action governed by a succession of action and response.

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<sup>34</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 646.

<sup>35</sup> See Benson, “Reciprocal Exchange as the Basis for Recognition of Law: Examples from American History”, *supra* note 8.

<sup>36</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 646.

<sup>37</sup> M. Taylor, *Community, Anarchy and Liberty* (Cambridge: Cambridge University Press, 1982) at 28.

<sup>38</sup> David Hume, *A Treatise of Human Nature*. ed. Selby-Bigge (Oxford: Clarendon, [1739] 1978) at 291.

<sup>39</sup> “This strategy is simply one of cooperating on the first move and then doing whatever the other player did on the preceding move. Thus TIT FOR TAT is a strategy of cooperation based on reciprocity.”

Axelrod, “The Evolution of Cooperation”, *supra* note 197 at 1393.

<sup>40</sup> Francesco, Parisi, and Nita Ghei, “The Role Of Reciprocity In International Law” (2003) 36 *Cornell International Law Journal*. 93 at 93.

## 2.1 The Importance of Reciprocity in the Absence of External Coercion

In theories of spontaneous law such as those of Fuller and Hayek, reciprocity plays a critical role, as it is this element that allows for a fairly stable system of order to emerge.<sup>41</sup> In systems where there is no external enforcement, “coercion” must exist in the form of mutual self-interest.<sup>42</sup> While this reciprocity need not necessarily be immediately realized, it underpins all systems of law where exogenous coercion is not present. Benson explains that “reciprocity has implications for the evolution of moral behaviour because it means that an individual can face an immediate choice of bearing costs by recognizing another’s property rights but perhaps without an immediate gain, in expectation of future reciprocal behaviour by someone else.”<sup>43</sup> It is the force of reciprocal gain that renders such systems effectual, infusing the notion of legal duty with a sense of personal consequence.<sup>44</sup> Indeed, Benson carries this point one step further, arguing as he does in his paper *The Spontaneous Evolution Of Commercial Law* that because customary law’s authority is based on a voluntary recognition that comes from the reciprocal gains of such recognition, as a consequence it is “much less likely to be violated than enacted law, imposed by a state and lacking reciprocity.”<sup>45</sup>

Thus, as Fuller points out “...duties generally can be traced to the principle of reciprocity...”<sup>46</sup> Indeed, Fuller concludes that “there is a notion of reciprocity implicit in the very notion of duty—at least in the case of every duty that runs toward society or

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<sup>41</sup> See especially the section *Reciprocity and the morality of duty* in chp. 1 in Fuller, *The Morality of Law*, *supra* note 3.

<sup>42</sup> See *supra* note 16.

<sup>43</sup> B.L. Benson, “Economic Freedom and the Evolution of Law” (1998) 18 *Cato Journal*. 209 at 211.

<sup>44</sup> See *supra* note 16.

<sup>45</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 660.

<sup>46</sup> Fuller, *The Morality of Law*, *supra* note 3 at 22.

toward another responsible human being.”<sup>47</sup> In fact, Fuller argued that the legitimacy of customary law in general sprung from “the principle of consensual reciprocity of expectations.”<sup>48</sup> In a system that requires voluntary compliance, reciprocity must be present in one form or another in order to induce this willingness to comply.

Parisi and Ghei look at the role of reciprocity in international law in a game theoretic framework, concluding that reciprocity is an essential component in its functioning—an element that should be considered a “meta-rule” in the system of international law.<sup>49</sup> Although they do not look specifically at commercial law, their findings likewise apply to the emergence of international commercial law, which like the rules of public law formulated by sovereign states, advances in the absence of a single overarching authority capable of enforcing compliance. Here, “the concept of reciprocity assumes peculiar importance in a world where there is no external authority to enforce agreements, that is in a world that exists in a Hobbesian state of nature. Historically, norms of reciprocity have been vital in escaping lives that that would otherwise be ‘solitary, poor, nasty, brutish and short’...Such a strategy permits cooperation in a state of nature, when no authority for enforcement of agreements exists.”<sup>50</sup> Parisi and Ghei point out that international law in fact exists in such a state of nature, with no authority possessing jurisdiction to enforce agreements.<sup>51</sup>

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<sup>47</sup> *Ibid.* at 21.

<sup>48</sup> Robert S. Summers, *Lon L. Fuller, Jurists: Profiles in Legal Theory* (London: Edward Arnold, 1984) at 79.

<sup>49</sup> Francesco, Parisi, and Nita Ghei, “The Role Of Reciprocity In International Law” (2003) 36 *Cornell International Law Journal*. 93 at 94.

<sup>50</sup> *Ibid.* at 93.

<sup>51</sup> *Ibid.*

Reciprocity, in this sense, is of paramount importance. Self-interest corrals the actions of individuals with disparate interests into efficient coordination—it is in this way a basic principle of such social order. Moreover, the more stark the manifestation of this element of reciprocity is in a given social arrangement, the easier the system can function without resort to external coercion. This is because actors are more clearly conscious of what benefit they derive from the arrangement. The nature of the relationship issues an implicit appeal to their own self-interest; thus, the lure of reciprocal benefit encourages compliance. If the reciprocal quality to the relationship is clearly laid out, participants are less likely to be confused as to why they should comply in the absence of coercion. In a sense, the coercion is internal.

In systems of commercial relations this principle is especially salient. Commercial intercourse is wholly predicated upon reciprocity. This principle in effect underpins the entire enterprise. In voluntary commerce, reciprocity is the purpose of the interaction—this is the basic nature of exchange. Further, in commercial interactions, parties are far more likely to be calculating their actions according to parameters of self-interest, and are considerably less likely to be influenced by ‘peripheral’ considerations, such as notions of equitable social conduct etc. From within such a milieu, concepts of rational choice theory in fact more readily apply as commercial arrangements are, for the most part, more clearly premeditated, being constructed around a less nuanced agenda. Some approaches in Neo Institutionalism in the rational choice tradition assume that “individuals make decisions based on how they perceive and weigh the expected costs and benefits of alternative courses of action.”<sup>52</sup> In commercial interaction, where the primary motivation

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<sup>52</sup> Ferris, James M. “The New Institutionalism and Public Administration: An Overview” (1993) 3 *Journal of Public Administration Research and Theory*. 4 at 5; See also G. Radnitzky, “Cost-Benefit Thinking in

for participation is unambiguously to glean individual profit, this weighing of expected costs and benefits is far more clear-cut. The clarity of interests that arises from a relationship defined by reciprocity helps induce compliance. This principle of gain—a vitalizing force compelling the actions of rational actors—is commercial law’s distinguishing mark.<sup>53</sup>

## 2.2 Reciprocal Gain and Self-interest as the Root of all Law

Now, to some extent, individual benefit lies at the heart of the formulation of and subsequent compliance with all forms of law, whether commercial in nature or not. As Fuller expresses, “Exchange is, after all, only a particular expression of this more general, and often more subtle, relationship [reciprocity].”<sup>54</sup> Elsewhere Fuller writes, “...the reciprocity out of which a given duty arises can be visible, as it were, in varying degrees. At times it is obvious to those affected by it; at others it traces a more subtle and obscure course through the institutions and practices of society.”<sup>55</sup> In this way then, reciprocity may be understood as the root of all law.

Individual benefit is the primary engine of all norm emergence—our chief carrot. To take criminal law as an example, something that on its surface seems well removed from this

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Methodology of Research: The ‘Economic Approach’ Applied to Key Problems of the Philosophy of Science.” In G. Radnitzky and P. Bernholz, eds. *Economic Imperialism” The Economic Method Applied Outside the Field of Economics* (New York: Paragon house, 1987).

<sup>53</sup> Fuller writes, “The literature of the morality of duty is in fact filled with references to something like the principle of reciprocity. Even in the midst of the exalted appeals of the Sermon on the Mount there is a repeated note of sober reciprocity. ‘Judge not, that ye be not judged. For with what judgment ye judge, ye shall be judged; and with what measure ye mete, it shall be measured to you again...’” On the same page Fuller continues, “Traces of this conception [reciprocity] are to be found in every morality of duty, from those heavily tintured by an appeal to self-interest to those that rest on the lofty demands of the Categorical Imperative. Whenever an appeal to duty seeks to justify itself, it does so always in terms of something like the principle of reciprocity...In this broad sense there is a notion of reciprocity implicit in the very notion of duty—at least in the case of every duty that runs toward society or toward another responsible human being. (Fuller, *The Morality of Law*, *supra* note 3 at 20-21.)

<sup>54</sup> Fuller, *The Morality of Law*, *supra* note 3 at 20-21.

<sup>55</sup> *Ibid.* at 22.

element of profit; arguably compliance is similarly motivated by self-interest and the pursuit of personal advantage. In the case of criminal law, this is compliance with rules so as to ultimately advance one's own personal safety (although admittedly a somewhat Hobbesian view of human nature). At its most basic level, it is an exchange of sorts: I will not harm you if you do not harm me. All law in this way can be said to be in a sense contractual. And, indeed, like commerce, it too is predicated on the control and protection of property. Property here being property in truly its most basic sense: the integrity of the physical person.

Hayek indeed has a more general conception of property, seeing it as the basis of law in the sense of universal rules of conduct. For him notions of property “determine boundaries of the domains of freedom by laying down rules that enable each to ascertain where he is free to act.”<sup>56</sup> In this sense, the reciprocal recognition of property, property in even the most abstract sense, is the basis of all forms of law. In the words of Hayek, “Law, liberty, and property are an inseparable trinity.” Thus, individual benefit gleaned from a basic acknowledgment of ownership (i.e. property of any kind) underlies the formulation of all law. Hayek writes in *Law, Legislation and Liberty*,

The understanding that ‘good fences make good neighbors, that is that men can use their own knowledge in the pursuit of their own ends without colliding with each other only if clear boundaries can be drawn between their respective domains of free action, is the basis on which all known civilization has grown. Property, in the wide sense in which it is used to include not only material things...is the only solution men have yet discovered to the problem of reconciling individual freedom with the absence of conflict.<sup>57</sup>

Hayek points out that this was “long regarded as self-evident and needing no proof. It was...clearly understood by the ancient Greeks as by...Milton and Hobbes through

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<sup>56</sup> Hayek, *Law, Legislation, and Liberty*, *supra* note 7 at 107.

<sup>57</sup> *Ibid.*

Montesquieu to Bentham and re-emphasized more recently by H. S. Maine and Lord Acton. <sup>58</sup> He goes on to assert that “the recognition of property preceded the rise of even the most primitive cultures, and...certainly has grown up on the basis of that spontaneous order of actions which is made possible by the delimitation of protected domains of individual or groups.”<sup>59</sup> In one sense then, all law addresses issues of property, from criminal law to family law, to constitutional law. Indeed, this is a certain understanding of law.

In a sense, law of any kind then may be said to be contractual in nature, concerning questions of property.<sup>60</sup> Such a broad understanding of the term ‘property’ is consistent with much of the law and economic analysis of law literature.<sup>61</sup> After all, what is law but a vast consensus to abide by certain rules, much in the same way a contract entails the consent of two or more parties to align their behaviour in accordance to the stipulations of an agreement. Indeed, the “social contract” can be said to be a contract in a very real sense of the word. We might think of it as a standard form contract, incrementally drawn

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<sup>58</sup> *Ibid.*

<sup>59</sup> *Ibid.* at 108.

<sup>60</sup> Posner in particular adopts a singular commercial approach to the adjudication of law in arguing that economic considerations form the underlying rationale to the workings of the entire common law. For Posner, judicial opinions, even when not explicitly couched in economic terms nor recognized as such, are in reality addressing issues that are purely economic in nature: “[Common law] doctrines form a system for inducing people to behave efficiently, not only in explicit markets, but across the whole range of social interactions. In settings in which the cost of voluntary transactions is low, common law doctrines create incentives for people to channel their transactions through the market...In settings in which the cost of allocating resources by voluntary transactions is prohibitively high making the market an infeasible method of allocating resources, the common law prices behaviour in such a way as to mimick the market.” (Posner, Richard. *Economic Analysis of Law (6<sup>th</sup> edition)* (Chicago: Aspen Law & Business, 2003) at 251-2.) In this view, all law deals in aspects of property in some form or another; it is at its heart concerned with the adjudication of property. In so far as Posner sees the adjudication of the common law as predicated upon matters that are ultimately economic, law can be reduced to a system for coordinating forms of property, from the tangible to the extremely abstract.

<sup>61</sup> “...the connection between markets and property has induced stipulatively wide definitions of the term ‘property’ among some members of the school [the modern economic analysis of law]: any right which a person may agree not to insist on (whether personal, familial or political) should be styled a ‘property’ right, because the right-holder has control over the effects of the exercise of the right on others (its ‘externalities’).” Harris, J. W.. *Legal Philosophies*. Second Edition (London: Redwood Books, 1997) at 46.

up by the social order as a monolithic whole, to which members of the public, through their participation in society, give consent. Consent being, in this way, implied. In the case of a formal contract, what we have is essentially a more specific and limited instance of this same process—the same paradigm is evident: rules are drawn up and parties agree to adhere to those rules.

In fact, if we could for a moment broaden our conventional notions of consent and contract, even positivist law enforced through the threat of punishment can, in a certain respect, be conceptualised as contractual. That is, parties comport themselves in accordance to the law because it is in their interests to do so, out of fear of punishment. Avoiding penal repercussions, in this instance, is incentive to comply with the law (putting aside other motivations for compliance such as a sense of moral duty etc.; this, of course, often comes into play, but we are interested here in situations where this is not present but nevertheless there is compliance). Thus, there is in a sense an exchange; a party adheres to the law and the state (collectively representing all the other members of society) refrains from imposing criminal sanctions. This can be seen as a contract between members of society with the instruments of the state simply as a tool of the contractors. That it is reciprocal is a personally relevant incentive to abide by the law. Seeing law in this way does admittedly require a certain philosophical leap of imagination. And of course this view would turn upon our definition of “coercion” and the principle of duress. Duress, obviously, would undermine consent, invalidating any “contract.” Seeing circumstances involving duress as reciprocal is arguably a tenuous

position when we look at the definition of duress.<sup>62</sup> It would require a significant departure from the conventions we normally ascribe to the term “contract.” However, the point I wish to convey here is that it can be said a semblance of reciprocity is manifest in all forms of law. Even in the most extreme examples of coercion we can still find traces of reciprocal gain undergirding the law. Reciprocity is in a way embedded into the very nature of voluntary human interaction. Although it may take different forms and vary in intensity, self-interest underlies compliance, and in this sense, the act of acquiescence can be understood as a contractual-like exchange. At the end of the day, regardless of what form of law we are considering, an element of Individual benefit characterizes legal compliance—traces of self-interest lie at its heart in one form or another.

### **2.3 The Unique nature of Commercial Law**

However, as we have said, commercial activity is unique as this principle of benefit is commerce’s chief characteristic. In stark and unequivocal terms, it is its defining feature. In the realm of commerce, it thus emerges as a far more quantifiable phenomenon. Gain is virtually the sole reason for the activity. With the emergence of law such as criminal law, there are arguably other factors that come into play, such as the human impulse towards moral conduct and so forth; in family law and constitutional law, there are the influences of social custom and fundamental political conceptions at work. However, with commerce, what we have is a distilled version, an almost pure version of human self-interest. And as such what emerges through the prism of commercial intercourse is a system of interaction based more or less exclusively on the principle of individual gain. In commerce this feature is more pronounced—it is its basis and sole measure of its

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<sup>62</sup> The definition of duress: “threat of harm made to compel a person to do something against his or her will or judgment; esp., a wrongful threat made by one person to compel a manifestation of seeming assent by another person to a transaction without real volition.” *Black's Law Dictionary*, 8th ed., s.v. “duress.”

efficiency. The effect of this is that while to some extent this principle of self-interest may be found within all forms of law, in commercial law it is profoundly more manifest, and thus commercial law offers itself up as the definitive illustration of this phenomenon. It is one extreme end of a spectrum, a far more tangible display of this dynamic, and thus may be clearly distinguished from all other forms of law.

This aspect of reciprocity is the core constituent of a self-regulating system of legal relationships. Thus, commercial law is perfectly positioned to evolve and function in a unique manner, without the necessity of resorting to the potency of state-backed coercion.

#### **2.4 Reciprocity as a Distinguishing Property of Spontaneous Commercial Order**

Interestingly, in describing the core properties of systems of spontaneous order, Hayek asserts that such systems will often consist of abstract relations between elements, recognizable only

...on the basis of a theory accounting for their character. The significance of the character of such orders rests on the fact that they may persist while all the particular elements they comprise, and even the number of such elements, change. All that is necessary to preserve such an abstract order is that a certain structure of relationships be maintained, or that elements of a certain kind (but variable in number) continue to be related in a certain manner.<sup>63</sup>

Arguably, systems of commercial regulation correspond exactly to such a description. In trade, the manner in which elements are related is one of reciprocity. The potential to achieve some measure of gain through mutual cooperation and reciprocation is the basis of commercial interaction. A system of commercial law comprises a myriad of countless participants bound together by the common thread of reciprocity—the essence of trade. In

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<sup>63</sup> Hayek, *Law, Legislation, and Liberty*, *supra* note 7 at 37.

this sense, the feature of reciprocity forms the underlying structure of all these numerous relationships—precisely the abstract relation between elements that Hayek describes when he speaks of the properties of a spontaneous order. The potential to satisfy mutual self-interest is the engine that drives commercial trade. If this element is removed, a system of voluntary commercial relationships cannot continue.

In his discussion of the Law Merchant, Trakman points out that reciprocity indeed serves as the organizing basis to systems of commerce: “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.”<sup>64</sup> Reciprocity is, in this way, the distinctive property of systems of spontaneous commercial order. This, according to Trakman, is borne out by the historical emergence of the law merchant in the Middle Ages as well as in the modern manifestation of the *Lex Mercatoria*. Today as much as ever, “Reciprocity, in the sense of mutual benefits and costs, is the very essence of trade.”<sup>65</sup>

## **2.5 Contractual Ordering, Customary Law, and Reciprocity**

If, as we mentioned earlier, commercial law stands at one extreme end of a spectrum in terms of the principle of reciprocity, customary law in the pure sense of the word, lies at its absolute tip. It can be said that customary law is wholly grounded upon and

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<sup>64</sup> Trakman, Leon E. *The Law Merchant: The Evolution of Commercial Law* (New York: Fred B Rothman & Co, 1983) at 7.

<sup>65</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 649.

constructed around the principle of reciprocity.<sup>66</sup> In this respect, contractual ordering comes nearest to customary law in the pure sense of the term. Indeed, Fuller described customary law as the inarticulate brother of contract.<sup>67</sup>

Being so close on this continuum, the same forces that induce the ‘spontaneous’ emergence of norms in systems of customary law are also present in contract-based law. Contract-based law shares many of the basic characteristics of customary law, specifically its reliance upon the element of reciprocity.<sup>68</sup> Depending upon the definition one chooses to adopt, it can be said commercial law is in fact a certain incarnation of customary law.<sup>69</sup> Contract law is a more explicitly articulated form of customary law, with terms precisely spelled out—its clear-headed older brother. I would argue that its preciseness, in fact, allows the underlying force of reciprocity to work with even greater effect; contract law’s clarity of expression gives greater force to the element of reciprocity in the commercial relationships it creates. In this sense then, contract-based law could be said to be even more responsive to this principle of reciprocity than customary law, which at times might present a relatively muddled expression of

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<sup>66</sup> In situations involving customary norms where reciprocal benefit may not be immediately clear, there will be an underlying benefit to be gained from such custom in the form of collective benefit of the group as a whole, which presumably would benefit the party who is complying with the “law.” In such situations, the norm will carry with it a flavour of *opinio iuris ac necessitates*, that it just seems like the right thing to do: that there is a general belief in the widespread desirability of the norm and a conviction that it is an essential norm of conduct. This might manifest simply in the form of a sense of social obligation to comply. As Parisi observes, “...only those practices recognized as socially desirable or necessary will eventually ripen into enforceable customary law. Once there is a general consensus that members of a group ought to conform to a given rule of conduct, a legal custom can be said to have emerged when some level of spontaneous compliance with the rule is obtained.” Francesco Parisi, “Spontaneous Emergence Of Law: Customary Law” (96<sup>th</sup> Annual Conference Of The American Political Science Association, Washington, D.C., August 31-September 3, 2000). 603 at 606.

<sup>67</sup> Lon L. Fuller, *Anatomy of the Law* (New York: Frederick A. Praeger. 1968) at 108.

<sup>68</sup> See generally Francesco Parisi, “Spontaneous Emergence Of Law: Customary Law” (96<sup>th</sup> Annual Conference Of The American Political Science Association, Washington, D.C., August 31-September 3, 2000). [Parisi, “Spontaneous Emergence Of Law: Customary Law”]

<sup>69</sup> Robert S. Summers, *Lon L. Fuller, Jurists: Profiles in Legal Theory* (London: Edward Arnold, 1984) at 81.

reciprocity, creating instead merely a vague sense that the norm seems socially appropriate; the element of reciprocity may at times get lost in the mix as it were. This is not so with contract law. As we have said, the unambiguous structure of a contractual relationship is one that is entirely oriented towards achieving some degree of mutual benefit. Reciprocal benefit is its life's blood—the sole reason for its formation. This unequivocal nature, one predicated exclusively on the self-interest of the contracting parties, brings the element of reciprocity to the fore, establishing it as the basic governing principle under which parties coordinate their actions. In agreeing on terms, in arranging the rules that will oversee their interaction, the goal of achieving some kind of reciprocal benefit is the principle to which parties will turn. Thus, reciprocity can be said to play an even greater role in contract-based relationships than any other kind of association.

The parallels between contract and customary law was of great interest to Fuller.<sup>70</sup> Fuller wrote extensively on customary law, theorizing on its similarity with systems of contractual ordering. In doing so, Fuller was concerned with certain forms of contract. Fuller focussed on longer term contractual arrangements that allowed for the emergence of continuous cooperation between the contracting parties, such as: partnership agreements, franchises, labour contracts, contracts for the long term supply of goods, and so forth. He also includes in this: bank accounts, bonds, insurance policies, and other long-term contractual claims.<sup>71</sup> For Fuller, these contractual arrangements possessed similar features with that of customary law in terms of their dependence upon reciprocity.

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<sup>70</sup> See generally Fuller, *The Morality of Law*, *supra* note 3.

<sup>71</sup> Robert S. Summers, *Lon L. Fuller, Jurists: Profiles in Legal Theory* (London: Edward Arnold, 1984) at 81.

These forms of contract and customary law are similar “in that neither is imposed by a third party, or from above, as it were. Both develop, rather, when a situation arises in which the parties involved have or come to have needs that can be met through mutual reciprocation.”<sup>72</sup> This represents an important feature, as it is through an incremental process of interaction predicated upon a dynamic of reciprocity that norms in both forms of law emerge, essentially sidestepping the need for law to be created by a third party authority. In place of a legislature, the participants themselves formulate the pertinent rules. In place of statute, the terms of their agreement predominate; parties essentially create their own ‘statute’ through the terms they agree upon. In Customary law, norms evolve gradually from tacit understandings gleaned from repeated interaction.<sup>73</sup>

In terms of enforcement, reciprocal benefit also plays a key role here. Customary law theory asserts, “individual actors gradually come to embrace norms that they view as requisite to their collective wellbeing.”<sup>74</sup> In this way, the very reciprocal quality that ushers the arrangement into existence, at the same time serves as an enforcement mechanism, promoting compliance. For the most part, the vast majority of contracts are fulfilled without having to go to court largely because “they are mutually advantageous, not because of any threats of force.”<sup>75</sup>

Arguably, many forms of customary law stand apart from contract in that they are not enforceable. However, this distinction falters when we consider that some forms of

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<sup>72</sup> *Ibid.*

<sup>73</sup> Fuller, “Human interaction and the law”, in *The Principles of Social Order: Selected essays of Lon L. Fuller*. Edited by Kenneth I. Winston (Durham: Duke University Press, 1981) at 218.

<sup>74</sup> Parisi, Spontaneous Emergence Of Law: Customary Law”, *supra* note 68 at 603.

<sup>75</sup> Robert S. Summers, *Lon L. Fuller, Jurists: Profiles in Legal Theory* (London: Edward Arnold, 1984) at 81.

contract law also cannot be enforced. For example, this would be the case where parties stipulate against judicial enforceability, or a term is too unclear to warrant such enforcement. Nonetheless, such a contract may still be considered ‘lawful.’

There is, in contract and customary law, an element of reciprocity underlying both forms of law. If our specific customary law dictates that I should not play with live electrical wires in my yard while my neighbour is swimming in his pool, I would do so with the expectation that such a behavioural norm would be reciprocated when it is I who is swimming. Likewise, if our contract states I will deliver 1000 sticks of chewed gum to you on Tuesday with the expectation of payment, I would expect you to pay me if I manage to get 1000 sticks of chewed gum into your hands on Tuesday. In both cases, reciprocity undergirds the arrangement. The rule evolves because it confers a degree of mutual benefit, and, equally, it is (for the most part) complied with because of this quality of reciprocal benefit.

In contrast to other forms of law where reciprocity does not emerge with such vivid clarity as its primary characteristic, the element of reciprocity is more pronounced in systems of commercial law (as it is usually in customary law<sup>76</sup>). It is, therefore, important for us to appreciate the significance of reciprocity within systems of commercial law before we go on to examine how it is that commercial regulation itself may in fact be conceptualized as an instrument of the market, shaped to a large extent by the very market forces that it seeks to administer.

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<sup>76</sup> Paris states, “An enforceable custom emerges from two formative elements: (a) a quantitative element consisting of a general emerging practice; and (b) a qualitative element reflected in the belief that *the norm generates a desired social outcome*. Parisi, Spontaneous Emergence Of Law: Customary Law”, *supra* note 68 at 605.

### 3. Commercial Law as an Instrument Of The Market

Commercial law is unique in the degree to which the element of reciprocity is active in it. This element of reciprocity is an intrinsic feature of trade. Seen through a certain lens, commercial law is arguably not in fact the product of laws at all, but rather the product of market forces—inevitable corollaries that arise in conjunction with and assist commercial activity. Indeed, Benson argues that commercial law should be understood in this way.<sup>77</sup> A commercial system is in its essence “an evolving process of interaction and reciprocity which is simultaneously facilitated by and leads to an evolving system of commercial law.”<sup>78</sup> This view of commercial law holds that “evolving trade practices [provide] the primary rules of evolving commercial law.”<sup>79</sup> Commercial law in fact “develops directly from the market exchange process as business practice and custom evolves.”<sup>80</sup> That is to say, commerce is not merely subject to law; law (at least commercial law) is, to a great extent, subject to commerce. It is, in a manner of speaking, an instrument of the market.

#### 3.1 Fuller’s Horizontal Law and Hayek’s Order of Actions

In *The Morality of Law*, Fuller emphasizes law not only as an enterprise, but one that in fact mirrors the market order.<sup>81</sup> In doing so, he cites the significance of customary law<sup>82</sup> as a framework of spontaneously evolving rules arising from a dynamic process of

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<sup>77</sup> See generally Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5.

<sup>78</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 644.

<sup>79</sup> *Ibid.* at 660.

<sup>80</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 645.

<sup>81</sup> Barry Macleod-Cullinane, “Lon L. Fuller And The Enterprise Of Law” (1995) 22 Legal Notes 1995. 1 at 1.

<sup>82</sup> In looking at customary law, Fuller drew in part on the work of Eugen Ehrlich, specifically in regards to Ehrlich’s concept of “living law.” Robert S. Summers, *Lon L. Fuller, Jurists: Profiles in Legal Theory* (London: Edward Arnold, 1984) at 78. For a good summary of Ehrlich’s concept of Living Law, see Banakar, Reza, and Travers, Max. *An Introduction to Law and Social Theory* (Oxford and Portland, Hart Publishing, 2002) at 42-49.

dispute arbitration and adjudication.<sup>83</sup> Like Bruno Leoni, Fuller recognizes a certain advantage in the self-coordinating properties of customary law.<sup>84</sup> This, Fuller calls examples of “horizontal forms of order” contrasted with “vertical” systems of order imposed by the state.<sup>85</sup> Unlike “vertical” law, “Horizontal forms of order” are not predicated upon coercion. Thus, “just as a society may have rules imposed on it from above, so it may also reach out for rules by a kind of inarticulate collective preference.”<sup>86</sup> In Fuller’s view then, there is a sense that law is in fact most compatible with the market order. Indeed, many scholars have noted the similarity in the spontaneous manner in which the body of law that regulates the market and the market itself evolve.<sup>87</sup>

In his 1973 seminal work, *Law, Legislation, and Liberty*, Hayek puts forward a similar notion regarding law. Discussing the emergence of order, or systems, structures as he defines the term, Hayek contends there are two ways in which order can originate: ‘made’ and ‘grown’ order.<sup>88</sup> The latter demonstrates a degree of similarity to the concept that underpins Fuller’s notion of horizontal forms of order. For these two forms of order, Hayek use the Greek terms *taxis* to denote made order, and *kosmos* for a grown order.<sup>89</sup> Hayek explains that a made order may “be described as a construction, an artificial order

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<sup>83</sup> Barry Macleod-Cullinane, “Lon L. Fuller And The Enterprise Of Law” (1995) 22 Legal Notes 1995. 1 at 1.

<sup>84</sup> See Bruno Leoni, *Freedom And The Law* (Indianapolis: Liberty Fund, 1991), esp. chp. 5, “Freedom and legislation”.

<sup>85</sup> Fuller, *The Morality of Law*, *supra* note 3 at 233.

<sup>86</sup> Fuller, “Human interaction and the law”, in *The Principles of Social Order: Selected essays of Lon L. Fuller*. Edited by Kenneth I. Winston (Durham: Duke University Press, 1981) at 216.

<sup>87</sup> See generally C. Menger, *Problems of Economics and Social Biology*. Trans. by F.J. Nook. (Urbana, Ill.: University of Illinois Press, 1963); Hayek, *Law, Legislation, and Liberty*, *supra* note 7; M. Polanyi, *The Logic of Liberty: Reflections and Rejoinders* (Chicago: The University of Chicago Press, 1951).

<sup>88</sup> Hayek, *Law, Legislation, and Liberty*, *supra* note 7 at 35.

<sup>89</sup> Hayek, *Law, Legislation, and Liberty*, *supra* note 7 at 37. Hayek gives an explanation of these terms: “Classical Greek was more fortunate in possessing distinct single words for the two kinds of order, namely *taxis* for a made order, such as, for example, an order of battle, and *kosmos* for a grown order, meaning originally a ‘right order in a state or a community’.

or, especially where we have to deal with a directed social order, as an organisation.”<sup>90</sup> Legislated law would fall under this category. He describes this as an exogenous order. Hayek continues, “The grown order, on the other hand, which we have referred to as a self-generating or endogenous order, is in English most conveniently as a spontaneous order.”<sup>91</sup> Hayek distinguishes between the “order of actions” and the “order of rules”, suggesting that in the same fashion that a particular order of action may arise from a pre-existing pattern of social behaviour, the order of rules may also emerge spontaneously and without the requirement for deliberate design.<sup>92</sup> Hayek maintains that although the rules upon which a spontaneous order rests may be deliberately made, these rules may similarly be of spontaneous origin.<sup>93</sup>

### **3.2 Early Traces of Spontaneous Law Theory**

The idea that law can arise from the spontaneous ordering of market activities is a significant contribution of Hayek. Constituents of the idea, however, can be traced back much earlier. Indeed the concept that law should evolve largely spontaneously in a decentralized fashion rather than formulated by any one external authority, is a core principle within the common law. In fact, it is arguably its defining characteristic. Within a loose framework of statute, the common law grows through judicial precedent in an almost organic fashion, the product of countless individual contributions to its overall progression. The belief that, because of this, the law displays an ‘inner wisdom’ and greater rationality as it emerges slowly from an array of specific cases, and thus is better able to accommodate a vast multiplicity of facts and circumstances—is a central tenet of

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<sup>90</sup> Hayek, *Law, Legislation, and Liberty*, *supra* note 7 at 37.

<sup>91</sup> *Ibid.*

<sup>92</sup> *Ibid.* at 98; See also B.L. Benson, “Economic Freedom and the Evolution of Law” (1998) 18 *Cato Journal*. 209 at 209.

<sup>93</sup> Hayek, *Law, Legislation, and Liberty*, *supra* note 7 at 45.

English common law. In this sense, it is superior because it is the product of many minds. Describing this distinctive feature of the common law, Sir Matthew Hale, the renowned 17<sup>th</sup> century English jurist explained, "it is a reason for me to preferre a Lawe by which a Kingdome hath been happily governed four or five hundred yeares than to adventure the happiness and Peace of a Kingdome upon Some new Theory of my owne....."<sup>94</sup> This assertion, in fact, has a striking parallel with more modern economic theories regarding the development and equilibrium of market systems.

While in the latter half of the 20<sup>th</sup> century this notion of jurisprudence was greatly expanded upon and tied to economic principles by Hayek, it is in fact grounded upon the earlier theories of Adam Smith, David Hume, Adam Ferguson, and Edmund Burke.<sup>95</sup> It is in the work of these thinkers that we first discern the nascent concept of spontaneous social order. Of these, perhaps Adam Smith is best known for advancing this position. In the *Wealth of Nations*, Smith posits a theory of economic society that possesses a self-regulating system of spontaneous order.<sup>96</sup> And this order, in his view, arises naturally in an unpremeditated fashion from a confluence of disparate forces unintentionally working in coordination with one another. Writing on the division of labour he explains that it is not

the effect of any human wisdom, which foresees and intends the general opulence to which it gives occasion. It is the necessary, though very slow and gradual consequence of a certain propensity in human nature which has in view no such extensive utility: the propensity to truck, barter and exchange one thing for another.<sup>97</sup>

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<sup>94</sup> Sir William Holdsworth, *A History of English Law*, vol. V. (London: Methuen & Sweet & Maxwell, 1924) at 504.

<sup>95</sup> Barry Norman, "The Tradition of Spontaneous Order" (1982) 5 *Literature of Liberty*. at 6.

<sup>96</sup> *Ibid.* at 14.

<sup>97</sup> Smith, Adam. *An Inquiry into the Nature and Causes of the Wealth of Nations*. Edited by R. H. Campbell & A. S. Skinner (Oxford: Clarendon Press, 1976) at 25.

Thus, this blind interdependence brings about a spontaneous order—an ‘invisible hand’ that guides the market place. Smith explains that as each individual member pursues his own limited interests “he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.”<sup>98</sup> Describing the same phenomenon, Adam Ferguson, defines this process as one that stems largely from (a phrase later adopted by Hayek) “the result of human action, but not the execution of any human design.”<sup>99</sup>

### 3.3 Menger, Hayek and the Austrian School of Economics

The economist Carl Menger has a similar notion regarding jurisprudence. Menger conceptualizes law as an example of what he calls *organic* phenomenon, the aggregate result of natural processes.<sup>100</sup> Menger opines that “law, even the state itself...and numerous other social structures are already met with in epochs of history where we cannot properly speak of purposeful activity of the community as such directed at establishing them.”<sup>101</sup> Hayek is more adversarial in his appraisal. Hayek condemns what he views as the argument of “constructivist rationalism”<sup>102</sup> which he sees as underpinning the legal positivist position, stating that the argument is grounded upon “the fiction that all the relevant facts are known to some mind, and that it is possible to construct from this knowledge of the particulars a desirable social order.”<sup>103</sup> Hayek argues that within the field of economics, the price mechanism works to synchronize the diverse and limited knowledge of each individual member, allowing a spontaneous self-organization to

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<sup>98</sup> *Ibid.* at 456.

<sup>99</sup> Ferguson, Adam. *An Essay on Civil Society* (Edinburgh: Edinburgh University Press, 1966) at 122.

<sup>100</sup> Barry Norman, “The Tradition of Spontaneous Order” (1982) 5 *Literature of Liberty*. at 10.

<sup>101</sup> Carl Menger, *Investigations into the Method of the Social Sciences with Special Reference to Economics*, with a new introduction by Lawrence H. White, ed., Louis Schneider, Trans., Francis J. Nock, (New York and London: New York University Press, 1985) at 146.

<sup>102</sup> Hayek, *Law, Legislation, and Liberty*, *supra* note 7 at 8-34.

<sup>103</sup> *Ibid.* at 14.

emerge. Hayek coined the awkward term “catallaxy” to describe this self-organizing system of voluntary co-operation.<sup>104</sup> For an economist like Hayek observing the emergence of order within the subtle and highly interconnected flux of market systems, the possibility of law arising more or less spontaneously from the mechanics of economic forces was not only feasible, it was the most likely. This idea of spontaneous order in fact became central to the Austrian school of economics’ reformulation of economic theory (in which Menger and Hayek are key figures). At the core of classical liberalism lies the belief that from an unfettered market system, a spontaneous order of cooperation in exchanging goods and services can develop.<sup>105</sup> Indeed, the notion that order can emerge as the product of the voluntary actions of a multitude of individuals operating in blind coordination, and not through the legislative manoeuvring of the state—is a key idea in the classical liberal and free market tradition; it is a basic premise of economic libertarianism, and continues to be to this day.<sup>106</sup>

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<sup>104</sup> Hayek derived the word "Catallaxy" from the Greek verb *katallasso* (καταλλάσσω) meaning "to exchange", "to admit in the community" and "to change from enemy into friend." (Hayek, *Law, Legislation, and Liberty*, *supra* note 7 at 108-109. See also at 185) "To refer to the complex system that assures coordination of individuals' acts Hayek uses the term spontaneous order or catallaxy. According to him, spontaneous order consists of those institutions that are the result of human action but not the result of some specific human intention. In other words, spontaneous order or catallaxy is a network of firms and households and has no specific purpose of its own; rather it serves as a process by which individuals and organizations pursue their own purposes. Catallaxy is that which results naturally from the interaction of firms and households through the market exchange." Judit Kapás, "The Coordination Problems, the Market and the Firm" (2006) 2 *New Perspectives on Political Economy*. 13 at 20.

<sup>105</sup> Sally Razeen, *Classical Liberalism and International Economic Order: Studies in Theory and Intellectual History* (London: Routledge, 1998) at 17.

<sup>106</sup> This idea finds full expression in the intriguing theories of Anarcho-capitalism (a unique variant on Anarchist theory), of which Murray N. Rothbard is perhaps the best-known proponent (also an Austrian School economist). Anarcho-capitalism is an anti-state political philosophy that argues for an economic system based upon the voluntary trade of private property and services without the existence of state government. The theory calls for the complete elimination of the state, seeing free-market capitalism, unrestrained by the coercive and subverting interference of a state, as the true basis of a free society. Rothbard distinguishes free-market capitalism as a "peaceful voluntary exchange" in contrast to the corrupted influence of "state capitalism" which he sees as an economic system employing the collusion of government and private business interests in an effort to subvert the free market so as to gain monopolistic advantages – a "violent expropriation" of property. "The difference between free-market capitalism and state capitalism is precisely the difference between, on the one hand, peaceful, voluntary exchange, and on the other, violent expropriation." (Murray N. Rothbard, "A Future of Peace and Capitalism" in *James H. Weaver, ed., Modern Political Economy* (Boston: Allyn and Bacon, 1973) at 419-430.) David D. Friedman expanded on the ideas of Rothbard, arguing that a system of law can emerge reflexively from the

### 3.4 Understanding Commercial Law as an Invisible Hand

B.L. Benson, building on the ideas of both Fuller and Hayek (and ultimately Menger and the Scottish Enlightenment thinkers as well), has written extensively on the notion that commercial law tends to evolve naturally in line with the needs of commerce. This represents a significant shift away from the more traditional conceptions of law espoused by legal positivism. Benson argues that the development of commercial law can be likened to the natural evolution of commercial systems. In *The Spontaneous Evolution of Commercial Law*, Benson contends that similar to “the invisible hand” explanation for the emergence of market systems, commercial law evolves because it facilitates commercial activity, making it more efficient.<sup>107</sup> Benson writes,

“...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...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 design of any absolute authority. Commerce and commercial law have developed coterminously, without the aid of and often despite the interferences of the coercive power of nation-states because there is a mechanism in place. Commercial law itself is analogous to the price system in that it facilitates interaction and makes exchange more efficient. The underlying mechanics are also analogous. Commercial law

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functioning of the market, maintaining that “law will be produced for profit on the open market.” (Friedman, David. *The Machinery of Freedom*. Second edition (La Salle, Ill: Open Court Publishing Company, 1971) at 116-117.) Under Anarcho-capitalism, an entire legal framework will be constructed solely from individuals entering into contractual agreements thereby recognizing certain legal rights—a “contractual society.” This would be a system of order “based purely on voluntary action, entirely unhampered by violence or threats of violence...interpersonal actions that are purely voluntary, and have no trace of hegemonic relations...[which are] actions based on violence or the threat of violence.” (Murray N. Rothbard, *Man, Economy, And State: A Treatise On Economic Principles* (Princeton, New Jersey: D. Van Nostrand Co., 1962) at 84-85) That is to say, a system without the need to resort to state enforcement of laws. Morris and Linda Tannehill argue against the existence of statutory law in any incarnation, maintaining that all form of “crime” would essentially fall within the ambit of contract and tort law. (Susan Love Brown, *The Free Market as Salvation from Government: The Anarcho-Capitalist View, Meanings of the Market: The Free Market in Western Culture*, edited by James G. Carrier, (Berg: Oxford, 1997) at 113.) Anarcho-capitalism is also designated by a range of other terms such as: anti-state capitalism, market anarchism, polycentric law, the private-law society, private-property anarchy, pure capitalism, radical capitalism, stateless capitalism, stateless society, and stateless liberalism. (Hoppe, Hans-Hermann. “Anarcho-Capitalism: An Annotated Bibliography” (2001), online: Lew Rockwell <<http://www.lewrockwell.com/hoppe/hoppe5.html>>.)

<sup>107</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 645.

develops directly from the market exchange process as business practice and custom evolves.”<sup>108</sup>

In this sense, the emergence of commercial law is mainly a result of naturally evolving forces. That is, commercial law, similar to “the invisible hand” explanation for the emergence of market systems, evolves primarily because it facilitates commercial activity, making it more efficient. In this way, Benson maintains that commercial law is, so to speak, an instrument of the market.

Benson argues that both the enterprise of law that supports a free market and the market itself actually tend to evolve spontaneously through similar processes. He argues that rules and governmental institutions evolve as the unintended outcomes of individuals separately pursuing their own goals in the same way commercial structures develop.<sup>109</sup>

Benson contends that commercial regulation is as Hayek maintains, “the result of human action but not of human design.”<sup>110</sup> Thus, commercial law is, in a very real sense, an instrument of the market, emerging in reaction to the same forces that shape commerce.

Commercial law is not so much imposed by an external authority, but rather evolves spontaneously subject to the internal mechanisms that underlie commercial systems. It is, to a degree, a voluntarily produced body of law. Bentham famously wrote that “before the [state’s] law there was no property” take away the law, all property ceases.”<sup>111</sup>

However, within the realm of commercial law, arguably there is more to the story than this. Certainly, some law is necessary to regulate the exchange of property and the

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<sup>108</sup> *Ibid.*

<sup>109</sup> See B.L. Benson, “Economic Freedom and the Evolution of Law” (1998) 18 *Cato Journal*. 209. [Benson, “Economic Freedom and the Evolution of Law”]

<sup>110</sup> Hayek, F.A.. *Studies in Philosophy, Politics and Economics*. Chicago: University of Chicago Press, 1967. p. 77. See also Hayek, *Law, Legislation, and Liberty*, *supra* note 7 at 37.

<sup>111</sup> Bentham, Jeremy. *Works*, Vol. 1, edited by John Browning. (Edinburgh: W. Tait, 1859) at 309.

enforcement of property rights, but this may not be such a one-way relationship. In a sense, commerce, in turn, produces and shapes the law that evolves to regulate it.

### **3.5 Spontaneous Legal Evolution and the Law Merchant**

#### **3.5.1 The Law Merchant as a Creation of the Market**

In advocating for the plausibility of the spontaneous evolution of commercial law, Benson takes particular notice of the development of the medieval Law Merchant.<sup>112</sup> The Law Merchant evolved from common usage rather than from official edict. In many respects, the Law Merchant exemplifies the ability of commerce to generate law in response to commercial needs. As the Law Merchant was, as Fuller would say, a form of horizontal law, formulated spontaneously by traders themselves rather than imposed from on high through the legislative will of a state, it reflected the needs of day to day commerce—it was, in many respects, a creation of the market, facilitating the machinery of trade. Commerce was, in this sense, not just subject to the edicts of the Law Merchant, the Law Merchant was also, very much, subject to commerce.

Benson engages in a historical analysis of the nature of this evolution, tracing its absorption by the common law during the rise of the modern state, and the eventual reemergence of the law merchant as a primary force in current international commercial trade, where it still continues to evolve.<sup>113</sup> Benson concludes that the “[d]evelopment of

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<sup>112</sup> There has been several historical analysis of this kind examining other self-ordering arrangements. These include: the Maghribi Traders; medieval Iceland; Maine and mining camps in the American West. See respectively, Avner Greif, “Reputation and Coalitions in Medieval Trade: Evidence on the Maghribi Traders” (1989) 49 *Journal of Economic History*. 857; David Friedman, “Private Creation and Enforcement of Law: A Historical Case” (1979) 8 *Journal of Legal Studies*. 399; John Umbeck, *A Theory of Property Rights with Applications to the Californian Gold Rush*, (Iowa State University Press, 1989); Terry L. Anderson, and Peter J. Hill, “American Experiment in Anarcho-Capitalism: The *Not so Wild, Wild West*” (1979) 3 *Journal of Liberation Studies*. 9.

<sup>113</sup> See generally Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5.

trade required simultaneous development of law, but commercial law could not develop without changing requirements in trade. Thus, evolving trade practices provided the primary rules of evolving commercial law.”<sup>114</sup> Further, Benson contends that this evolutionary process could not have been achieved through intentional design.<sup>115</sup> Thus, the Merchant law is a clear example of a system of “spontaneous” law arising from the maelstrom of repeated and sustained commercial interaction—not the artefact of a central authority predicated upon coercion, but rather the living creation of the market itself.

In the tenth, eleventh and twelfth centuries, merchants across vast swaths of Europe broke the bonds of political constraints and created an international system of law to facilitate the burgeoning system of trade developing in their midst. During this period “the basic concepts and institutions of modern Western mercantile law—*lex mercatoria* (The Law Merchant)—were formed, and, even more importantly, it was then that mercantile law in the west first came to be viewed as an integrated, developing system, a body of law.”<sup>116</sup> By the eleventh century, every aspect of commercial trade in Europe, and even beyond the borders of the continent, was governed by the principles of the Law Merchant. This system of law was “voluntarily produced, voluntarily adjudicated and voluntarily enforced. In fact, it had to be. There was no other potential source of law, including state coercion.”<sup>117</sup> This was not new; “Custom, not law, has been the fulcrum of commerce since the origins of exchange.”<sup>118</sup>

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<sup>114</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 660.

<sup>115</sup> *Ibid.*

<sup>116</sup> Berman, Harold J. *Law and Revolution: The Formation of Western Legal Tradition*. (Cambridge, Mass.: Harvard University Press, 1983) at 333.

<sup>117</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 647.

<sup>118</sup> Trakman, Leon E. *The Law Merchant: The Evolution of Commercial Law* (New York: Fred B Rothman & Co, 1983) at 7.

### 3.5.2 The Law Merchant Reinforced Business

The laws which came to dominate the Law merchant worked to reinforce commercial practices. It emerged among the merchant community because local laws were not responsive enough to the changing needs of commerce. With the expansion of trade, there arose a need for a body of law that was quick and efficient in character, administered by specialized courts that understood business matters. In response to the needs of the market place, the system of law that emerged was notably expeditious and swift. This characteristic was to accommodate traders who often had to settle transactions quickly and move on to the next fair or market.<sup>119</sup> Long delays threatened the efficiency of trade. The Law Merchant arose in response to this commercial necessity.

The Law Merchant was a tool of unified commercial discourse that transcended the hotchpotch of differing local systems of law that traders would encounter, such as ecclesiastical, manorial, or civil.<sup>120</sup> The Law Merchant, as a uniform code that achieved a measure of standardization of practice in trade, served a critical function. This universality was a requirement of the evolving system of exchange. The Law Merchant created a universal law of trade, itself representing an essential advancement in commerce. Without recourse to such a uniform code of law, merchants would be faced with a dizzying diversity of local customs. This legal uniformity was something comparable to the standardization of railway track gauges in the 19<sup>th</sup> century<sup>121</sup>; it

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<sup>119</sup> Benson, "The Spontaneous Evolution of Commercial Law", *supra* note 5 at 650.

<sup>120</sup> Barry Macleod-Cullinane, "Lon L. Fuller And The Enterprise Of Law" (1995) 22 Legal Notes 1995. 1 at 5.

<sup>121</sup> Douglas J. Puffert, "Path Dependence in Spatial Networks: The Standardization of Railway Track Gauge" (2002) 39 Explorations in Economic History. 282 at 282-314. See the chp. 7 below for a more in depth exploration of path dependency and legal norms.

provided a standard upon which the enterprise could flourish. The emergence of a standardized system of law proved invaluable to the enterprise of trade:

As international trade developed, the benefits from a uniform rules and uniform application of those rules superseded the benefits of discriminatory rules and rulings that might favor a few local individuals. By the twelfth century, commercial law had developed to a level where alien merchants had substantial protection in disputes with local merchants, and ‘...against the vagaries of local laws and customs’.<sup>122</sup>

A degree of consistency in the rules overseeing trade was absolutely vital in allowing a system trans-regional exchange to develop. The law merchant represented what Fuller calls a “language of interaction”<sup>123</sup>, an instrument of communication between a community of merchants from disparate cultural and political settings, with a limited degree of mutual trust. The growing commercial needs of merchants traveling between these various regions demanded a uniform and commonly recognized system of law to facilitate the common objectives of commerce. Merchants from all across medieval Europe would travel across vast distances to exchange goods in fairs and village markets with parties they knew little about nor shared a common cultural bond.<sup>124</sup> In this setting, localized and contradictory legal customs were a significant impediment to the free flow of commerce. Thus, a clear system of rules to oversee their trade was a necessity.

As these traders engaged in commercial interaction, business customs became increasingly better defined and less arbitrary. The law merchant grew out of such repeated dealings among traders because it further facilitated the ability of these merchants to engage in the act of trade. The law that arose was, in a very real sense, in response to the requirements of the market—*an instrument of the market*. As Trakman

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<sup>122</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 648.

<sup>123</sup> Lon L. Fuller, *The Principles of Social Order: Selected essays of Lon L. Fuller*. Edited by Kenneth I. Winston (Durham: Duke University Press, 1981) at 213.

<sup>124</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 649.

explains, "...the law itself was a subordinate force, a reflection of the will of the merchants. Legal rules were required to reinforce what the parties wished, not to replace their aspirations with extrinsic demands."<sup>125</sup> Law arose to assist the endeavour of commerce, and as trade was impacted by these procedural improvements, it in turn induced further legal adjustments in the law: the law merchant was in a sense a kind of symbiotic development.

The emergence of credit is an example of this. Benson points out that by the Twelfth century "the main forms of credit extended by sellers to buyers were promissory notes and bills of exchange."<sup>126</sup> Prior to this period, the practice of negotiability of credit instruments did not exist.<sup>127</sup> Negotiability of credit, a critical innovation that allowed trade to flourish, "was 'invented' by Western merchants because of the need for improved means of exchange as commerce developed..."<sup>128</sup> This itself was largely because "the rise of the Law Merchant generated sufficient confidence in the commercial system so that a reservoir of commercial credit could be established."<sup>129</sup> Here we see an interesting example of how the market initiated a legal development, which in turn allowed for even more market changes. This process was recurrent throughout the development of the Law Merchant.

Legal devices evolved during this period as a response to the needs of the market. Every "procedural or substantive legal rule in the Law Merchant thus had a practical

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<sup>125</sup> Trakman, Leon E. *The Law Merchant: The Evolution of Commercial Law* (New York: Fred B Rothman & Co, 1983) at 10.

<sup>126</sup> Benson, "The Spontaneous Evolution of Commercial Law", *supra* note 5 at 651.

<sup>127</sup> *Ibid.*

<sup>128</sup> *Ibid.*

<sup>129</sup> *Ibid.*

genesis.”<sup>130</sup> A good example of this was the recognition of a document lacking notarial execution as valid so long as it was signed by the relevant parties, as this greatly aided in the speed of transactions and reduced costs.<sup>131</sup> Likewise, rules regarding the passing of property without actual physical delivery evolved in order to address problems associated with the geographical impediments traders typically encountered.<sup>132</sup> The body of law that emerged was a response to the requirements of market; its overarching orientation was that of facilitating the act of commerce. This was done incrementally and in a decentralized fashion. It was as Benson argues, a process that “evolved without the design of any absolute authority” because it “facilitate[d] interaction and ma[de] exchange more efficient.”<sup>133</sup>

In the absence of state coercion, viable merchant courts emerged along trade routes and trading centres to resolve the legal disputes that would invariably arise between merchants. Benson asserts that parties to a legal claim would accept the courts decisions largely out of fear of commercial ostracism, a common penalty for those who refused to accept the ruling of the court.<sup>134</sup> “The threat of boycott of all future trade ‘proved, if anything more effective than physical coercion.’”<sup>135</sup> Trakman writes, “Reciprocity and the threat of business sanctions compelled performance.”<sup>136</sup>

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<sup>130</sup> Trakman, Leon E. *The Law Merchant: The Evolution of Commercial Law* (New York: Fred B Rothman & Co, 1983) at 14.

<sup>131</sup> *Ibid.* at 14-15.

<sup>132</sup> *Ibid.* at 15.

<sup>133</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 645.

<sup>134</sup> *Ibid.* at 650.

<sup>135</sup> *Ibid.* at 649.

<sup>136</sup> Trakman, Leon E. *The Law Merchant: The Evolution of Commercial Law* (New York: Fred B Rothman & Co, 1983) at 10.

Over time, merchant ‘business practices’ were increasingly put into writing in the form of written commercial instruments and contracts.<sup>137</sup> Thus, the Law Merchant arose from the pages of contracts voluntarily entered into by merchants. These contracts were not law in the sense of codified commercial legislation drafted by the disinterested minds of government, but rather predicated upon the specific agreements drawn up by traders themselves. Invariably, the Law Merchant would gradually incorporate these contractual usages. In every aspect of the Law Merchant, the contract itself was the focal point of all legal issues; the agreement between traders was of absolute dominance in these matters. All other questions were “subservient to its dominating function as a regulator of behaviour.”<sup>138</sup> The Agreement formed the cornerstone of the Law Merchant precisely because this law arose to serve the requirements of trade, before all else this was its overriding objective.

### **3.5.3 The Law Merchant Sprang from Business Customs**

“The law,” Trackman informs us, “did little more than echo the existing sentiments of the merchant community.”<sup>139</sup> The rules of the Law Merchant were an expression of the commercial practices merchants themselves instituted in order to facilitate exchange between them. The Law Merchant sprang from the business customs prevalent at the time, which emerged as they assisted the undertaking of trade. A fundamental respect for the merchant practice as a primary source of regulation reverberated through the evolution of the Lex Mercatoria. The law “reinforced rather than superseded the cycle of

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<sup>137</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 649.

<sup>138</sup> Trakman, Leon E. *The Law Merchant: The Evolution of Commercial Law* (New York: Fred B Rothman & Co, 1983) at 10.

<sup>139</sup> *Ibid.* at 9.

business practice. It commanded merchants to do that which they themselves had promised to do. Moreover, it generally avoided complex legal forms and mandatory controls over business that had not already been sanctioned either in custom or in commercial habit.<sup>140</sup> The law was seen very much as a secondary source of regulation, a suppletive body of law,<sup>141</sup> standing along side the entrenched business practices of the day.<sup>142</sup> The Law Merchant emerged in response to the needs of Merchants. Above all, it was functional rather than ideological.<sup>143</sup> It was formulated to govern the dealings of traders, and was itself an administrative reflection of the requirements of these dealings.

It is, however, debatable as to whether or not the medieval Law Merchant truly could be considered a unified single market. Local governments did at times attempt to exert influence over the law governing trade in their region to gain some relative commercial advantage for local traders.<sup>144</sup> The Merchants of Antwerp, for instance, refused “to submit to the law of London, on the ground that the law of London discriminated against them.”<sup>145</sup> Local merchant courts were not always impartial, often favouring local merchants over foreign traders.<sup>146</sup>

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<sup>140</sup> *Ibid.* at 18.

<sup>141</sup> Citing Trakman’s footnote: “A distinction between mandatory law (*ius cogens*) and suppletive law (*ius depositivum*) is well known, as a matter of doctrine, in continental legal systems.” *Ibid.* at 138.

<sup>142</sup> *Ibid.* at 19.

<sup>143</sup> Trakman, Leon E. “From the Medieval Law Merchant to E-Merchant Law” (2003) 53 *The University of Toronto Law Journal*. 265 at 274.

<sup>144</sup> Trakman writes, “...non-merchant influences upon tribunals undermined the commercial foundation of the Law Merchant. Royal ordinances were often a more significant force for change at fairs and markets than merchant practice...local merchant courts were not always impartial in their treatment of foreigners. As a reprisal for discrimination in foreign jurisdictions, commercial codes prevailing in Italian cities sometimes stipulated that aliens were to receive ‘no better law than their own citizens would have in the alien state.’...in some cases local merchant courts insisted that foreign merchants should bind themselves unconditionally to forum law, to the exclusion of all foreign law, even the law most familiar to one or both of the contracting parties.” Trakman, Leon E. *The Law Merchant: The Evolution of Commercial Law* (New York: Fred B Rothman & Co, 1983) at 19-20.

<sup>145</sup> *Ibid.* at 20.

<sup>146</sup> *Ibid.* at 19.

However, that in absence of a central authority, a relatively uniform system of commercial law did nevertheless emerge and thrive in medieval Europe despite these attempts at rent-seeking by local authorities, is astonishing, and indeed speaks to the degree to which market forces that required (require) a standardized body of law, created the commercial law of the period. The fact that in spite of this tendency towards local favouritism, the Law Merchant developed by the hands of merchants with disparate profit incentives, mutual distrust, and little in common, is stark testament to the power that market forces exert over the formation and functioning of commercial law.<sup>147</sup> Indeed, at its core, market forces created and sustained the Law Merchant.

### **3.6 The Modern Lex Mercatoria**

#### **3.6.1 The Law Merchant Survived**

The Law Merchant did not die with the emergence of the modern state; it was merely co-opted by national laws, and transformed.<sup>148</sup> It was subsumed by national commercial law codes. The Law Merchant, however, remained the principal source of commercial law in both the Common law and Civil law systems,<sup>149</sup> and has now reemerged in our present age. To some extent national law has fragmented the Law Merchant in its current incarnation, but it nevertheless continues to exist.<sup>150</sup> We are in a sense now witnessing the growth of a “new” Law Merchant, suggestive of its medieval counterpart.<sup>151</sup> “Like the medieval Law Merchant, a twenty- first-century Law Merchant is evolving that is

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<sup>147</sup> In fact, even after the adsorption of Law Merchant into State law, elements of the Law Merchant still levied a considerable influence upon the courts.

<sup>148</sup> Trakman, Leon E. *The Law Merchant: The Evolution of Commercial Law* (New York: Fred B Rothman & Co, 1983) at 23.

<sup>149</sup> *Ibid.*

<sup>150</sup> Trakman, Leon E. “From the Medieval Law Merchant to E-Merchant Law” (2003) 53 *The University of Toronto Law Journal*. 265 at 283.

<sup>151</sup> Trakman, Leon E. *The Law Merchant: The Evolution of Commercial Law* (New York: Fred B Rothman & Co, 1983) at 39.

cosmopolitan in nature and transcends the parochial interests of nation states.”<sup>152</sup> And Like the medieval Law Merchant, the modern Law Merchant is above all tailored to meet the needs of the community of merchants from which it has evolved. Its guiding spirit is efficiency and pragmatism because this is what the market requires.

### 3.6.2 The Law Merchant is Transnational in Character

As in medieval Europe, the existence of diverse regional legal jurisdictions represents a considerable risk to those engaging in trade across borders.<sup>153</sup> Business recognizes this. Thus, the “...general trend of commercial law [has been] to move away from the restrictions of national law to a universal, international conception of law of international trade.”<sup>154</sup> As with its forefather, the core philosophy of the modern Law Merchant “is pragmatism: commercial law is grounded in commercial practice directed at market efficiency and privacy...free from inefficient government intrusion. In line with this, mercantile disputes [are] resolved functionally and privately in light of commercial practice, not [through] state impositions on that practice.”<sup>155</sup> The ability of merchants to regulate their dealings through “their own business practices, their contracts, their customs and their usages”<sup>156</sup> is increasingly valued. In many respects, modern international commerce is governed by regulation largely the creation of the commercial sector itself.<sup>157</sup>

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<sup>152</sup> Trakman, Leon E. “From the Medieval Law Merchant to E-Merchant Law” (2003) 53 *The University of Toronto Law Journal*. 265 at 281.

<sup>153</sup> Trakman, Leon E. *The Law Merchant: The Evolution of Commercial Law* (New York: Fred B Rothman & Co, 1983) at 39.

<sup>154</sup> *Ibid.*

<sup>155</sup> Trakman, Leon E. “From the Medieval Law Merchant to E-Merchant Law” (2003) 53 *The University of Toronto Law Journal*. 265 at 283.

<sup>156</sup> Trakman, Leon E. *The Law Merchant: The Evolution of Commercial Law* (New York: Fred B Rothman & Co, 1983) at 39.

<sup>157</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 658.

### 3.6.3 The Widespread Use of Arbitration

The widespread use of dispute resolution as an alternative to local courts is testament to the ability (and the need) of merchants to adjudicate their own legal matters. By the middle half of the last century, approximately 75 percent of commercial disputes were settled through arbitration.<sup>158</sup> Today, it is standard practice for parties to write arbitration clauses into their contracts. Approximately “90 percent of international trade contracts written in the early 1990s contained arbitration clauses.”<sup>159</sup> Parties select arbitrators to apply the parties' choice of law. These arbitrators are chosen for their commercial expertise and tasked with conducting arbitral hearings “in light of merchant practice and trade usage.”<sup>160</sup> Indeed, many international trade associations offer internal conflict resolution procedures.<sup>161</sup> The International Chamber of Commerce (ICC) has created “a substantial arbitration institution.”<sup>162</sup> Such arbitration is strikingly pragmatic, exhibiting an underlying recognition of the accepted business practices of those immersed in the enterprise of international trade.

Not unlike its medieval predecessor, international commercial arbitration laws and procedures are remarkably standardized.<sup>163</sup> As Trackman points out, similar to the medieval Law Merchant, modern commercial arbitration is “surrounded by a *ius commune*, a law common to merchants...” Trackman explains, “This *ius commune* is evident in the codification of mercantile arbitration rules both within bi- and multilateral

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<sup>158</sup> *Ibid.* at 656.

<sup>159</sup> Benson, B. L. "International Economic Law and Commercial Arbitration," in *Economic Analysis of Law: A European Perspective*, Aristides, N. Hatzis, ed. (London: Edward Elgar, forthcoming). p. 1.

<sup>160</sup> Trakman, Leon E. “From the Medieval Law Merchant to E-Merchant Law” (2003) 53 *The University of Toronto Law Journal*. 265 at 282.

<sup>161</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 659.

<sup>162</sup> *Ibid.*

<sup>163</sup> Trakman, Leon E. “From the Medieval Law Merchant to E-Merchant Law” (2003) 53 *The University of Toronto Law Journal*. 265 at 282.

conventions, as well as in the rules of international commercial arbitration associations. That *ius commune* also includes, to varying degrees, a common substantive law, based on trade usage."<sup>164</sup>

Indeed, the basic components of the Law Merchant are alive and well: contract, trade usage, and commercial arbitration. In many ways, the basic principles of international commercial law are a current reflection of the medieval law merchant: choice of arbitration institutions, procedures, arbitrators and applicable law, and a overarching deference to recognized business customs and usages. These principles exist in response to the requirements of merchants engaging in trade. In large measure, international commercial law, the body of law that has arisen within a trans-regional context on the back of increasing commercial trade, is a product of deep-seated markets forces that usher it into being. The Law Merchant, past and present, informs us that commercial law is, in many respects, an instrument of the market; indeed, it is forged in part by the very commercial interaction it seeks to regulate.

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<sup>164</sup> *Ibid.*

#### 4. Fuller's Three Conditions Underpinning the Notion of Duty

Before continuing with this idea, however, let us return for a moment to Fuller. As mentioned, Fuller looked closely at the emergence of customary law, suggesting it follows from a basic sense of duty.<sup>165</sup> Fuller asks the question: “Under what circumstances does a duty, legal or moral, become most understandable and most acceptable to those affected by it?”<sup>166</sup> What Fuller means here by a notion of “duty” is basically a clear appreciation of the reciprocal nature underlying the relationship. That is, what exactly if anything they get out of it. It is this understanding that spurs men into action. In a sense, we could speak of it as a duty ultimately to one’s own self-interest. As we have discussed, in the absence of third-party enforcement, it is clear that “reciprocal arrangements are the basic source of the recognition of duty to obey law (and of law enforcement when state coercion does not exist).<sup>167</sup>

So in what circumstances does an appreciation of reciprocity, and thus a recognition of duty, most clearly arise? Fuller concludes that “we may discern three conditions for the optimum efficacy of the notion of duty. *First*, the relationship of reciprocity out of which the duty arises must result from a voluntary agreement between the parties affected; they themselves ‘create’ the duty.<sup>168</sup> *Second*, the reciprocal performances must in some sense be equal in value.”<sup>169</sup> And, “[t]hird, the relationships within the society must be

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<sup>165</sup> Fuller, *The Morality of Law*, *supra* note 3 at 19-23.

<sup>166</sup> *Ibid.* at 22-23.

<sup>167</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 646.

<sup>168</sup> A contractual relationship, we can assume, meets this criterion. An argument can be made that individuals sometimes are ‘forced’ into business relationships out of economic necessity, with this being a form of financial duress. In this sense, the truly voluntary nature of the relationship could be questioned. However, for Fuller’s purposes, this would still qualify as a relationship of reciprocity resulting from a voluntary agreement as all that is required under Fuller’s definition is a clear recognition of the benefit gleaned from the interaction. Thus, the choice can still be said to be voluntary in so far as that particular agreement goes.

<sup>169</sup> Fuller, *The Morality of Law*, *supra* note 3 at 23.

sufficiently fluid so that the same duty you owe me today, I may owe you tomorrow—in other words, the relationship of duty must in theory and in practice be reversible...These, then are the three conditions for optimum realization of the notion of duty; the conditions that make a duty most understandable and most palatable to the man who owes it.”<sup>170</sup> Fuller then goes on to ask, bearing these three principles in mind, in what kind of community would customary norms most easily emerge. His answer is an interesting one: Fuller suggests that it is in fact *in a society of economic traders* that the necessary conditions for the arising of a sense of duty and obligation is most prevailing.<sup>171</sup> Fuller explains that:

By definition the members of such a society enter direct and voluntary relationships of exchange. As for equality it is only with the aid of something like a free market that it is possible to develop anything like an exact measure for the value of disparate goods. Without such a measure, the notion of equality loses substance and descends to the level of a kind of metaphor. Finally, economic traders frequently change roles, now selling, now buying. The duties that arise out of their exchanges are therefore reversible, not only in theory but in practice. The reversibility of role that thus characterizes a trading society exists nowhere else in the same degree, as becomes apparent when we consider the duties running between parent and child, husband and wife, citizen and government.<sup>172</sup>

What we have then in a society of traders is a system centred on voluntary exchange, that has at its disposal a common unit of comparison (money), and which involves relatively fluid relationships with individuals frequently changing roles (as buyers and sellers).<sup>173</sup>

#### **4.1 Reciprocal Exchange should be Equal in Value**

The utility of money then as a mechanism through which reciprocal exchange may be measured with a pragmatic degree of precision, cannot be overstated. Through the

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<sup>170</sup> *Ibid.* at 23-24.

<sup>171</sup> *Ibid.*

<sup>172</sup> *Ibid.* at 24.

<sup>173</sup> Barry Macleod-Cullinane, “Lon L. Fuller And The Enterprise Of Law” (1995) 22 *Legal Notes* 1995. 1 at 6.

discourse of the market, goods and services may be accurately quantified and assigned a value. The availability of such a process greatly facilitates such exchanges. Certainly it would be hard for parties to conveniently arrive at consensus regarding the value of the exchange without the quantifier of money. If I had an apple, for example, that I wished to exchange for your dog, it would not be immediately clear how many apples a dog is exactly worth, and vice a versa. However, with the advent of money, prices can be more or less determined by the market, allowing for easier mutual understanding regarding the exchange. This would be more cumbersome in situations of barter (particularly if you did not want my apples). The use of money in this situation enables us to more efficiently recognize and quantify what exactly each of us is getting out of the deal. Thus, a common unit of comparison is an important condition when we speak of recognition of duty in the sense that it facilitates equal exchange, which in turn engenders a clear understanding of the reciprocal gain of the relationship.<sup>174</sup> In this way, the existence of money allows for a greater number of reciprocal relationships to be entered into, with these relationships being more sophisticated in nature. The market itself determines the value of disparate goods allowing for ‘equal’ exchanges. Thus, the intricate calibration of the market greatly aids in the formation of relationships of reciprocity.

#### **4.2 Fluidity of Roles: Role Reversibility**

Likewise, fluidity of roles is also important. The fluidity of commercial relations ensures a measure of fairness in both the creation of certain rules and the subsequent acquiescence to those same rules in situations that may not serve one’s immediate self-interest. One does so because one realizes one may be on the receiving end of those rules

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<sup>174</sup> It is interesting to note that in situations in which the reciprocal exchange is perfectly and clearly even, for instance, I refrain from murdering you and you return the favour, norms seem to emerge more manifestly.

in the future. Traders frequently change roles as buyers and sellers,<sup>175</sup> in other forms of law, roles are more fixed.<sup>176</sup> One's relationship to the law is far more clearly defined. For example, most individuals would have little misgivings about accepting a rule of criminal law that biases their own position at the expense of others, because they are surer of their own position in relation to that law. That is, if they can be confident they will never be subject to the sharp end of that law, they are not as likely to find it as objectionable.<sup>177</sup> With commercial situations, roles are not as clear or as stable. This principle of role-reversibility as articulated in a Rawlsian veil of ignorance or a Harsanyi veil of uncertainty, has an important role to play in the emergence of legal norms.<sup>178</sup> Here, however, it is enough to note its importance.

#### **4.3 Condition of Voluntariness Not Necessary**

It is clear then how having a common unit with which to facilitate even exchanges, and a general fluidity in participants' roles in these exchanges, are both compelling conditions fostering a certain respect for rules. It is not as clear, however, as to why voluntariness should be a factor that contributes to this recognition of duty. Looking at Fuller's three conditions, I would, in modesty, amend the list slightly. When we stop and break down this condition of voluntariness it appears that the situation is actually reversed from how he defines it. The voluntary nature of the interaction is not so much the cause that makes

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<sup>175</sup> Benson, "The Spontaneous Evolution of Commercial Law", *supra* note 5 at 647.

<sup>176</sup> Parisi (as does Benson) points out that "These conditions in fact occurred during the formative period of the medieval law merchant (*lex mercatoria*), when travelling merchants acted in dual capacity of buyer and seller. If they articulated a rule of law which was favourable to them as sellers, it could have the opposite effect when they acted as buyers, and vice-versa. This role reversibility changed an otherwise conflicting set of incentives (buyer versus seller) into one that converged toward symmetrical and mutually desirable rules. Parisi, Spontaneous Emergence Of Law: Customary Law", *supra* note 68 at 608.

<sup>177</sup> *Ibid.*

<sup>178</sup> For a detailed treatment of this principle as a means of inducing cooperative outcomes in game theory models, see Vincy Fon, and Francesco Parisi, "Role-Reversibility, Stochastic Ignorance, and the Social Cooperation" 3 George Mason University School of Law, Law and Economics Research Paper. 43 [Fon and Parisi, "Role-Reversibility, Stochastic Ignorance, and the Social Cooperation"].

a duty “most understandable and most acceptable to those affected by it”, but rather the result of the duty already being recognized as such. That is to say, Fuller’s first condition is perhaps a little bit of putting the cart before the horse. It is important for us to be clear: it is not so much a condition for the recognition of duty as it is a discernable characteristic of a kind of interaction where duty has already been recognized. It is, in effect, a marker with which to identify situations where norm formation has already occurred, rather than the direct cause of those situations—a subtle distinction to be sure but an important one.

Thus, regarding the first of Fuller’s three conditions, it would be a mistake to conclude that a duty is most recognizable in reciprocal relationships that are voluntary. This seems to be confusing a result for a cause. We should instead frame the relationship as one where the parties have *already* recognized the reciprocal benefit they derive from the arrangement, and as a result, voluntarily engage in it. The point I wish to make here is that if there were not already such recognition, they would not voluntarily enter into the interaction in the first place. This voluntary nature is thus an indication that the parties already appreciate the element of reciprocity undergirding their endeavour. There is no reason to assume that in situations where the norm is enforced, that the sense of duty is necessarily any less clear to the actors. So long as they are aware of the reciprocal gain they derive from the arrangement, the duty will “become most understandable and most acceptable” to the participants.<sup>179</sup> I am not clear why, as Fuller puts it, “the notion of voluntary assumption itself makes a strong appeal to the sense of justice...”<sup>180</sup> that is to say, a notion of duty. Rather, it is more the case that in the absence of any active enforcement, if parties are still engaging in these interactions, we can more or less safely

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<sup>179</sup> Fuller, *The Morality of Law*, *supra* note 3 at 23.

<sup>180</sup> *Ibid.*

conclude that they are already aware of the reciprocal benefit they accrue. Thus, this voluntary aspect is germane only as a clear sign that the actors already recognize the reciprocal nature of the relationship. would therefore drop this first condition, and in its place, add a new condition: that of high engagement. Thus, the conditions in which the notion of duty is most understandable to those affected by it are the following three: 1) the ability to conveniently gauge the equality of the exchange, 2) a general fluidity in roles, and 3) a *high level of engagement on the part of the participants*.

When these three conditions are present, as they are in relationships of commerce, a clear recognition of the principle of reciprocity tends to emerge, encouraging the formation of and compliance with the rules men formulate to govern their relations. Among these though, a high level of overall engagement is perhaps the most important. It is key because, more than any other factor, it accentuates the effects of reciprocity on men's dealings with one another. Fuller writes "the bond of reciprocity unites men."<sup>181</sup> True enough, but the bond of reciprocity becomes that much more powerful as the element of overall engagement increases. Reciprocity is crucial in systems of law lacking external coercion; indeed its importance, as we have seen, is well appreciated among spontaneous law theorists. The significance in the manner of engagement, however, is less understood. This all-important element of engagement is what we will turn to next, and serves as the central focus of the remainder of this paper.

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<sup>181</sup> *Ibid.*

## **5. The Concept of High Engagement Examined**

Let us now look at this element of high engagement. Actors in commercial activity demonstrate a generally higher level of engagement contrasted with other forms of regulated activities. The importance of this fact cannot be overstated; this characteristic of commercial dealings accentuates and amplifies the effect of reciprocity on the emergence of legal norms. Without it, the effects of reciprocity would not manifest as powerfully. Thus, seeking to explain norm evolution in commercial law, we must examine what relationship exactly the degree of engagement has with the ability of commercial systems to self-enforce.

But first, what exactly do we mean when we speak of engagement, and how is this unique to situations of trade and commerce? We are using the term engagement here to signify the extent to which players engage with one another and establish patterns of repeated or involved interaction. As we will see, a higher level of overall engagement translates into a greater willingness to adhere to the rules of the game.

This high level of engagement comprises two interrelated aspects of commercial law. These are: basic repetition and the creation of positive duties to act and game creation. In fact, these two aspects are inextricably linked; the second in effect paves the way for the emergence of the first. The characteristic of repeated interaction is able to manifest as it does in commercial dealings because of the nature of the interaction itself. While, for purposes of exposition, these two ideas are treated separately below, this should be borne in mind: they are intimately connected. As we will discuss below, the creation of positive

duties and game creation enhances the interaction's ability to be repeated. Let us look at repetition first.

### **5.1 Repetition**

Through their association, actors expand the general scope of their relations and repeat them, more and more frequently brushing up against situations that necessitate the involvement of rules to mediate their cooperative ventures. Arguably, this is true of every form of law in the sense that the primary function of law is to provide guidelines to which the behaviour of individuals must to some degree conform. However, with commercial interaction it is different. Commercial law is distinct in the sense that the players tend to be more frequently and consistently engaged in the activity (i.e. commercial trade) where it is often their very livelihood. Participants voluntarily enter into specialized situations that demand the attention of specific rules, and they do so on an exceedingly frequent basis. This stands in clear contrast to other areas of law such as criminal law or tort, where most individuals will infrequently, if at all, find themselves in direct contact with it. Further, while situations involving non-commercial law are more or less static, trade has the ability to both expand in scope and accelerate. This high level of engagement intensifies the cohesive effects of reciprocity on the relationship, encouraging rule compliance, simply because there are more cycles of interaction. To use once more the analogy of a saw, deeper grooves of cooperative norms are cut basically because the players run through the process more frequently—the blade is passed *repeatedly* over the spot. Looking at commerce, we see that the sheer frequency of interaction is profoundly greater than in non-commercial situations. To put it plainly: they are simply doing it more.

There are several important points regarding this characteristic of repetition that will be pointed out in this section: (1) the interaction is often repeated with the same players; (2) the frequency of repetition can increase; (3) new partners and new interactions are sought out, and (4) repetition has the effect of making players far more exposed to the law.

### 5.1.1 Repeat with same Players

The nature of commerce welcomes repetition. Successful cooperation will usually lead to repeated dealings, further expanding relations, all the while deepening the contact and familiarity the players have with the relevant rules governing their ventures. The tendency to target specific parties and engage in repeated dealings with them is a significant feature of commercial interaction as it plays a crucial role in inducing the emergence of cooperation. Ellickson contends that groups of “[p]eople who repeatedly interact can generate [legal] institutions through communication, monitoring, and sanctioning.”<sup>182</sup> For Fuller, one of the general conditions under which customary law can evolve and persist is that the occasions for interaction “must be sufficiently recurrent.”<sup>183</sup> Fuller calls this “the tacit commitments that develop out of interaction...”<sup>184</sup> Indeed, “Such interactional practices are often open-ended and oblique at the outset, and become refined and fixed only by a gradual process of adjustment and accommodation. They commonly ‘glide into being imperceptibly’...The stabilized practices that ultimately emerge are typically tacit, yet recurrent.”<sup>185</sup> The fact that parties often repeat their

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<sup>182</sup> Ellickson, R.C. “Property in Land” (1993) 102 Yale Law Journal. 1315 at 1366.

<sup>183</sup> Robert S. Summers, *Lon L. Fuller, Jurists: Profiles in Legal Theory* (London: Edward Arnold, 1984) at 80.

<sup>184</sup> Fuller, *The Morality of Law*, *supra* note 3 at 234.

<sup>185</sup> Robert S. Summers, *Lon L. Fuller, Jurists: Profiles in Legal Theory* (London: Edward Arnold, 1984) at 78.

interactions allows for the possibility of more sophisticated forms of cooperation between them. This characteristic of repeated interaction with the same participants has important implications to situations that display a Prisoner's Dilemma-type situation (how this is so we will delve deeper into in the following section). In the realm of commerce, it is in fact an almost universal objective to construct cooperative relationships that can be repeated; often the more frequent the better. This is not true for non-commercial law; there is no overarching effort to accelerate, expand, and repeat interactions.

### **5.1.2 Frequency Can Increase**

A further important point to be made is that with commercial law the frequency that the players interact with one another can continue to increase, constrained only by relevant market situations. There is, in theory, almost no ceiling to the extent of cooperation. While patterns of non-commercial interaction are typically fixed and have no reason to increase, commercial interactions are often accelerated and repeated. And to do so is a chief objective.

### **5.1.3 Seek Out New Partners**

Participants in commerce actively seek out new opportunities to construct new sets of relations with different parties. Commerce is an exercise in ceaseless expansion and repetition. Not only does the same interaction have the potential to be repeated again and again, but successful interactions will often lead to new ventures, again involving recognition of certain rules. As Benson explains, "As the benefits from one bilateral relationship evolve, incentives to develop similar benefits with others arise and a loose

knit group with intermeshing reciprocities begins to develop.”<sup>186</sup> New interactions create new opportunities for cooperation, not only with the original parties, but also with new participants. Likewise, opportunities for wholly new forms of interaction also emerge. One enterprise will often open a window to a new business venture, often with a new set of responsibilities and commitments. Thus, new contracts are formed to govern new forms of interaction.

#### **5.1.4 More Exposed to Law**

The end result of all this is that the participants in commercial interaction are considerably more exposed to the relevant law. In each interaction—dealings which often demand cooperation with parties they have little other relationship with beyond trade—they rely steadfastly on the collectively recognized rules. These rules serve as the chief constitution of their actions. Participants, in this way, find themselves constantly engaged in situations where these conventions are of primary importance; they are repeatedly exposing themselves to these rules. This is simply not the case for other areas of law. To use the example of criminal law, how frequently does the average person really find him or herself in contact with it? Perhaps once or twice in their lifetime, if at all. The particular rules of family law or tort do not directly affect individuals on a regular basis. Certainly, shadows of the law exist minimally in the background of their lives to the extent of maintaining order within the societies they live. However, law, for the most part, demands little or none of their explicit attention. It is not something with which they are highly engaged.

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<sup>186</sup> Benson, “Economic Freedom and the Evolution of Law”, *supra* note 109 at 211.

In contrast, communities of traders and merchants are in contact with commercial law on a daily basis where it is often their very livelihood. As a result, the law is of primary importance to them. They deal repeatedly with situations that explicitly demand adherence to certain rules, often tirelessly seeking to expand and increase these very situations. This is the primary aim to which they orient themselves, day in and day out. The rules they establish and adhere to in these interactions form a fundamental and familiar substratum to their lives. They are constantly engaged with these sets of rules, frequently finding themselves in situations where they must resort to them to overcome obstacles that threaten the success of the relationships they construct. Thus, these rules are of the utmost importance to them, permeating their daily lives.

Thus, with each new cycle of cooperation, their mutual recognition and adherence to the set of rules they have chosen to govern their relationship is further established and deepened. In this way, behavioural conventions evolve and become further entrenched. In a sense, they are constructing legal norms with each relationship they foster. In this respect, commercial interaction is markedly different from all other forms of interaction; we have in commercial intercourse a perpetual genesis of shifting responsibilities and duties to other individuals. It is this unique characteristic of commercial interaction that we are pointing to when we speak of commercial situations as possessing a high level of overall engagement. And it is because players are more engaged in the specific activity that fixed behavioural norms can emerge.

## **5.2 The Creation of Positive Duties to Act: Cycles of Interaction and Game**

### **Creation**

There is, though, another important distinction between commercial and non-commercial law that should be pointed out here. This is a second aspect of high engagement found in the basic nature of commercial interaction. While frequency and repetition as discussed above is one, albeit crucial aspect of high engagement, we must also consider the basic nature of the kind of action that commercial interaction issues into being. Ultimately, frequency and repetition is very much related to the particular form the interaction takes. They are inextricably related. The nature of commercial interaction in effect allows for repetition.

#### **5.2.1 Manner of Interaction allows for Repetition**

What we mean here by engagement is more than merely repetition. It is not only important to note that parties repeat these interactions, but it is also important to understand *what* exactly is being repeated, and *how* it is being repeated; that is to say, the kind of action that is repeated. When we speak of high engagement then, we are also referring to the nature of the interaction, not just its frequency. This is because the nature of the interaction itself allows for greater repetition—it lends itself to the possibility of more frequent repetition by providing a delineated cycle of interaction that may be run through again and again. Thus, it is important to recognize that commercial interaction not only differs from non-commercial law in terms of repeated cycles of interaction, the manner of the interaction itself is also of consequence. Let us now look more closely at the kind of interaction regulated by commercial law.

### 5.2.2 Creation of Positive Duties to Act

In a way, the types of action required by commercial and non-commercial law are polar opposites: in commercial law, participants are actively doing something; they are engaging in something as opposed to merely refraining from doing something. While non-commercial law, for the most part, regulates what people should not do, commercial law regulates what people are obliged to do (as well as what they should not do). The distinction perhaps seems simple, even obvious, but its simplicity should not be confused for unimportance; it has profound implications.

In *The Principles of Social Order*, describing customary law as a language of interaction, Fuller touches briefly on this idea that certain forms of law can be distinguished in that they involve a certain call to action (though he is speaking of customary law in general): “...what is involved is not simply a negation, a prohibition of certain disapproved actions, but also the obverse side of this negation, the meaning it confers on foreseeable and approved actions, which then furnish a point of orientation for ongoing interactive responses.”<sup>187</sup> This applies perfectly to the laws that regulate commercial interaction—specifically contract law. Like Fuller, I am here referring not to contract law in the traditional sense as in the law of contract, but to the “law” that a contract itself brings into being.<sup>188</sup> Patterns of commercial interaction are distinct from all other forms of law where legal injunctions are couched in purely negative terms, incurring penalty if violated: for example, the criminal law’s universal prohibition against murder, or tort law’s against

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<sup>187</sup> Lon L. Fuller, *The Principles of Social Order: Selected essays of Lon L. Fuller*. Edited by Kenneth I. Winston (Durham: Duke University Press, 1981) at 213-214.

<sup>188</sup> To quote Fuller: “...we shall be concerned here with contract as a source of social order, as one means for establishing ‘stable interactional expectancies.’...the term *contract law*, therefore, refers primarily, not to the law of or about contracts, but to the “law” a contract itself brings into existence.” Lon L. Fuller, *The Principles of Social Order: Selected essays of Lon L. Fuller*. Edited by Kenneth I. Winston (Durham: Duke University Press, 1981) at 224.

nuisance or trespass. Commercial law, in addition to the threat of sanctions, creates positive obligations between parties. It is wholly unique in this sense. It not only regulates how parties are to interact, essentially ‘criminalizing’ certain behaviour, it actively promotes the formation of completely new duties between agents, promoting new forms of association. To put it colloquially: with commercial law actors are actually actively doing something, while in other forms of law, they are not doing anything; rather they are refraining from doing something—an important distinction. Flipping through the criminal code of any nation state one will find scant few, if any, actual positive legal obligations towards other individuals. Non-commercial law is what one must *not* do to other individuals; it is not what one must do. That is, it is the maintenance of a certain social order as opposed to the proactive generation of wholly new cooperative structures. The basic distinction here is that law that arises from some sort of contractual union between parties builds new relationships, while virtually all other forms of law, for the most part, merely regulate existing relationships.<sup>189</sup> This is a fundamental distinction, and for our purposes, an important one, as this structure to commercial law pulls participants into a higher level of engagement with the law. And, in so doing, induces the emergence of stable legal norms, conventions on which to model one’s behaviour—all without the need of a central legislative body to enact law.

In commercial law, we have a specific well-defined kind of interaction that definite rules explicitly regulate. This is not so much the case in human relationships outside of commerce; the manner in which parties are to interact is not as clearly mapped out; only

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<sup>189</sup> The instances where positive duties to act arise in “non-commercial” areas of law, such as negligence, real property, criminal law and family law—the law, I would argue, although often not explicitly recognized as such, is in fact predicated on some form of contractual-like relationship (i.e. Fiduciary duty etc.).

injunctions are offered. What we have with commerce is essentially the wholesale creation of new networks of relationships, one that targets a specific end and is exceedingly specialized. In this way, it is the generation of new forms of interaction, positive duties to act, and not simply the regulation of existing relationships that are largely framed in the negative—injunctions against certain acts. That is, non-commercial law, for the most part, is the regulation of human interaction that already exists, while commercial regulation is in fact the further formation of kinds interaction. It is the active construction of a system of cooperation over and above mere prohibitions against harming other individuals. It instead seeks to aid in individuals' efforts at new forms of cooperation. This is an important distinction. In a sense, commercial society is something we create through the enterprise of trade, and is something that stands almost separate to the standard set of interactions that can be observed in society. It is an appendage, something that through our actions we are continually creating.

In so doing, we are essentially fashioning new avenues of human interaction, which in turn give rise to new systems of regulation to govern those relationships, assigning duties and responsibilities where previously there were none. These arrangements, with their myriad of obligations between parties, pull individuals, or sometimes-vast collections of individuals, into complex compositions of cooperation. These legal relationships are constantly being generated, with new forms of association arising continuously with each new commercial interaction. This constant flow of collaboration ensures the high engagement of the participants. They are called to act, rather than simply asked to refrain from acting. Within such networks of association, it is not enough to simply go about one's business so long as one does not interfere with others. Rather, one's business is, in

a sense, the business of others. In commercial arrangements, one essentially commits oneself to an array of responsibilities towards other individuals. Within this sphere of interaction, one's duties to others extend beyond simply not harming others through theft or physical injury. In no other areas of law do we witness such a wholesale construction of responsibilities and duties to other parties.

### 5.2.3 Arena to Create Law

This more active and engaged nature of commercial law puts participants in a better position to “create” legal norms. Owing to the engaged nature of trade, players have more opportunities to develop systems of cooperation characterized by a pattern of responses and counter-responses.<sup>190</sup> They are actively engaging with one another, creating a venue where law can, in a sense, be constructed through their actions. That is, law in the sense of legal norms that relate to their specific interaction. Through his or her individual participation each actor contributes to an incremental evolution of the law. Parties' ability to form contracts tailored to the specific manner of association in which they find themselves allows players to essentially construct law.

There are of course countless examples of this. One such illustration is the drafting of non-performance clauses in international crude oil contracts. These *force majeure* clauses are expressed in detailed terms, and each clause is formulated in the light of the unique requirements of the crude oil industry itself.<sup>191</sup> These provisions are specifically crafted by traders with an intimate knowledge of the industry, in order to establish contractual

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<sup>190</sup> This interplay of response and counter-response is an important point; one that we will return to in shortly when we discuss prisoner's dilemma game situations.

<sup>191</sup> Trakman, Leon E. *The Law Merchant: The Evolution of Commercial Law* (New York: Fred B Rothman & Co, 1983) at 48.

consequences that will ensue as a consequence of such things as political unrest, insurrection, or nationalization, in the international crude oil market.<sup>192</sup> These clauses often include other considerations peculiar to the oil industry, such as oil spills and pipeline blockages. These clauses are adopted in response to the demands of international transactions. They “comply with prior practices, involving past occurrences in world trade; and they embody new practices, reflecting current events in the energy market.”<sup>193</sup> Such clauses have evolved into standard provisions in modern international crude oil contracts; one example of how commercial actors themselves through the structuring of contracts tailored to their particular circumstances, may influence the creation of general legal norms. Unlike non-commercial activities, in commerce new systems of cooperation are constantly being formed. In other aspects of life, relationships between individuals are for the most part static and fixed. In commerce we have instead continually evolving subsystems of cooperation—new patterns of interaction.

#### **5.2.4 Commercial Trade as a Delineated Game: Game Creation**

The most important point to take away from this, however, is that this will affect the system’s ability to generate cooperation between individual actors. It does this by opening the door to a certain clarity regarding repetition. That is, there is something being actively done that can be repeated. The act of actively doing something, as opposed to refraining from doing something, has specific consequences regarding stimulating cooperation between parties. Repetition of interaction induces the emergence of norms and compliance with them. This generation of norms and compliance arises from repeatedly running through cycles of interaction. In the sense that commercial law

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<sup>192</sup> *Ibid.* at 47.

<sup>193</sup> *Ibid.* at 49.

generates clearly delineated cycles of interaction, cycles that are typically repeated again and again, it reinforces this process of norm creation through repetition. Thus, when we speak of repetition, we are speaking of the repetition of cycles of interaction, and commercial law, specifically contract, builds these cycles of interaction.

Trakman concludes that time plays a formative role in the emergence of trade custom and, ultimately, into its solidification into legal norms: “The advent of time fosters the growth of inter-party practices. Time permits practices to crystallize into business usage and ultimately into trade custom.”<sup>194</sup> This is absolutely true. Over time, trade practices will emerge and gain an increasingly widespread acceptance.<sup>195</sup> However, while Trakman sees the decisive mechanism here as time, I would submit that if we were to deconstruct the mechanics of this phenomenon, we would find that it is in fact the act of repeating cycles of engagement in which parties rely on these norms that actually induces this occurrence. Time is merely an approximate metric with which to get a sense of how many cycles of interaction have occurred. Thus, I would argue that it is more accurate to speak of cycles of engagement, or repetition, than merely time. And commercial law, by its nature, allows for more cycles of defined interactions.

The process of contract is essentially the creation of a delineated, clearly defined cycle of interaction. Because parties are actively engaged in these interactions, these cycles of interaction allow for intricate systems of cooperation to develop and evolve. It provides a demarcated set of actions that, in effect, facilitates the emergence of norms and

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<sup>194</sup> *Ibid.* at 2.

<sup>195</sup> Indeed, this has a certain legal recognition; for the formation of customary law, time is considered a key formative element. French jurisprudence traditionally recognizes forty years as the minimum for an international custom. The German legal system requires thirty. Parisi, Spontaneous Emergence Of Law: Customary Law”, *supra* note 68 at 612.

subsequent compliance with them; the process of actively doing something within the scope of a delineated sequence of interaction creates an arena in which cooperation can evolve. In the language of game theory, it is a clearly defined game, or period of a game. There is a clear cycle of interaction to be completed by the players. Thus, it is clear when actors have gone through a finished cycle. Commerce is game creation. That through the constraints of a game situation players can develop cooperation strategies has been well studied by notable names such as Maynard Smith<sup>196</sup> (in the field of biology) as well as Axelrod and Hamilton.<sup>197</sup> Significant contributions to the analysis of the evolution of social conventions have been made by philosophers such as Lewis.<sup>198</sup> More recent attempts at applying game theory to the evolution of legal norms have been made by Ellickson,<sup>199</sup> Parisi,<sup>200</sup> and Cooter,<sup>201</sup> to name a few. In that a contract-based relationship is a delineated game, the principles of game theory apply quite readily. Contract is essentially defining, in explicit terms, a “game” to be played by the participants. Each stage and sequence of the “game” is laid out before hand: contingencies are anticipated; possible outcomes of the “game” are addressed. A very specific sequence of response and

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<sup>196</sup> Maynard Smith, John. *Evolution and the theory of games* (Cambridge: Cambridge University Press, 1982).

<sup>197</sup> Robert Axelrod, and William D. Hamilton, “The Evolution of Cooperation” (1981) 211 *Science*. 1390 [Axelrod, “The Evolution of Cooperation”]; Robert Axelrod, “The Emergence of Cooperation among Egoists” (1981) 75 *The American Political Science Review*. 306 [Axelrod, “The Emergence of Cooperation among Egoists”]

<sup>198</sup> D. Lewis, *Convention: A Philosophical Study* (Cambridge, Mass.: Harvard University Press, 1969).

<sup>199</sup> R.C. Ellickson, *Order Without Law* (Cambridge, Mass.: Harvard University Press, 1991) [Ellickson, *Order Without Law*]; R.C. Ellickson, “The Aim of Order Without Law” (1994) 150 *Journal of Institutional and Theoretical Economics*. 97.

<sup>200</sup> Francesco Parisi, “Law as a Voluntary Enterprise” *The Jurisprudence of Liberty*, 111, S. Ratnapala & B.G. Moens eds., 1996; Parisi Francesco, and Ghei Nita, “The Role Of Reciprocity In International Law” (2003) 36 *Cornell International Law Journal*. 93; Parisi, Spontaneous Emergence Of Law: Customary Law”, *supra* note 68; Francesco Parisi, “The Formation Of Customary Law” (96TH Annual Conference Of The American Political Science Association, Washington, D.C., August 31-September 3, 2000); Francesco Parisi, “The Harmonization Of Legal Warranties In European Law: An Economic Analysis” (1st international congress of the society of European contract law, Rome (italy), June 8-9, 2001); Francesco Parisi, “Toward a Theory of Spontaneous Law.” (1995) 6 *Constitutional Political Economy*. 211.

<sup>201</sup> Robert D. Cooter, “Structural Adjudication and the New Law Merchant: A Model of Decentralised Law” (1994) 14 *International Review of Law and Economics*. 215. [Cooter, “Structural Adjudication and the New Law Merchant: A Model of Decentralised Law”].

counter-response, is stipulated. Put plainly, the rules of contract are the rules of a precise game to be played by the participants. In playing these “games”, parties repeatedly run through rounds of interaction, and this assists in the generation of norms. Put still another way, by defining a complete cycle of interaction, it allows for repetition more easily, because it basically provides something that can be repeated. With other forms of law, the activity at issue is not a clearly defined purposive interaction that parties can complete. Rather, the activity is one of inaction, of refraining from doing something. It is therefore not as clear when a cycle has completed itself. More often than not, it is a situation without any clear end; rather it is an ongoing process of refraining from some action or another.

Perhaps we could illustrate this dynamic with a simple analogy involving two situations: scenario A and scenario B. Scenario A here represents commercial interaction, and scenario B, non-commercial interaction. In scenario A, I ask you to call me everyday at exactly 9:00 pm, let the phone ring once and hang up, after which I will promptly call you back and give you a time to call again the following day. In scenario B, I simply ask you to never call me. In scenario A, there will emerge definite cycles of interaction that will lead to further cycles of dealings, i.e. a system of cooperation. With scenario B, it is not as clear when we have run through a pattern of interaction. The interaction as it were is not a clearly delineated and sequenced “game,” but rather is one game that is ongoing.

One could argue of course that not calling everyday conveys compliance, though it still would not be as clear a signal as actively calling me (perhaps you just forgot all about me). Indeed, contracts often stipulate parties must refrain from certain actions. However,

contracts will tether this inaction to a specific time or event, which nevertheless still allows the “game” to be sequenced. In doing so, a sequence of cooperation can still arise, as it will be clear when compliance (inaction) has been observed and the game (or a stage of it) has concluded. That is, even if a contract demands inaction, the terms of the contract will still create a clear delineated game to be played. With scenario B we are forever stuck on this one phase of interaction; there is no active construction of a system of cooperation. We are stuck perpetually in one “game.” There is no interplay in the sense of a sequence of actions to be performed. The game is not an iterated game, as they say in game theory parlance. Alas, this is the case with commercial and non-commercial interaction. There is a profound difference between them. The difference is one of engagement, that is, in actively doing something, and doing so in clear stages.

In fact, to modify scenario B so that it is a more accurate reflection of the kind of interaction typically regulated by non-commercial law, I would not even designate a particular person to not call me, but rather simply declare to society as a whole that no one should ever call me. Group size will inevitably come into play.<sup>202</sup> While in a very small group this might not be an issue as an individual will have a pretty good idea of who potential collaborators are, in large groups it will not even be clear who the participants in the game are. In a large group then, scenario A will, as commercial partnership does, essentially carve out a small group of collaborators from the larger one, clearly designating the players. The situation in our modified scenario B is open-ended

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<sup>202</sup> Group size has been an important feature of game theory research and one that has been much studied. Social dilemma research has shown that cooperation decreases in large groups, partly because players are less identifiable. See De Cremer, David, and Leonardelli, Geoffrey J. “Cooperation in Social Dilemmas and the Need to Belong: The Moderating Effect of Group Size” (2003) 7 *Group Dynamics: Theory, Research, and Practice*. 168; Kerr, N. L. “Illusions of efficacy: The effect of group size on perceived efficacy in social dilemmas” (1989) 25 *Journal of Experimental Social Psychology*. 287; Liebrand, W. B. G. “The effect of social motives, communication and group size on behaviour in a n-person multi-stage mixed-motive game” (1984) 14 *European Journal of Social Psychology*. 239.

and imprecise, players are unclear, and there is no concise, delineated game created as a result. This is, in fact, the nature of non-commercial law. Thus, in these forms of law, a cycle is not as clearly defined as it is in commercial interactions, where a game is explicitly delineated. The ability to run through these “games” helps create norms and a willingness to comply with the norms. This is a very important point. In contrast, non-commercial law does not involve the creation of small chunks of interaction, that is, intact games that can be played.

### 5.2.5 Cooperation Strategies and Iterated Games

The idea that commercial law can be thought of as the creation of repeated games is an intriguing and complex notion. It is one that probably deserves a far more detailed discussion regarding game theory than can be presented here. However, an attempt is made to outline the bare fundamentals of the idea below. Commercial cooperation, for the most part, represents a non-zero sum game.<sup>203</sup> That is, one party’s benefit does not have to come at the expense of the other party; both parties may glean some mutual advantage from their arrangement, as there is a collective creation of wealth. In most situations this reciprocal gain will ensure norm compliance. However, the problem arises in situations where this dynamic breaks down and Prisoner Dilemma<sup>204</sup> type scenarios emerge, where there is a ‘conflict between self-interest and the common good.’<sup>205</sup> It has been well documented that in such situations, defection will invariably become the dominant

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<sup>203</sup> There are many real-world examples of non-zero sum games of pure coordination, where “the payoffs are structured such that the players have strong individual incentives to choose strategies that will conjoin to produce cooperative results. Every motorists, for example, recognizes that there will be gains from a convention that requires all to drive on the right (or left) side of the highway; every user of a language gains if there is a consensus about the meaning of given words. It is unremarkable that players reach cooperative outcomes in these sorts of games.” Ellickson, *Order Without Law*, *supra* note 199 at 159.

<sup>204</sup> In a Prisoner’s Dilemma game “two individuals can each either cooperate or defect...No matter what the other does, the selfish choice of defection yields a higher payoff than cooperation.” Axelrod, “The Evolution of Cooperation”, *supra* note 197 at 1391.

<sup>205</sup> Ridley, M. *The Origins of Virtue* (New York: Viking Penguin, 1996) at 53.

strategy over cooperation, forming a Nash Equilibrium of non-cooperation.<sup>206</sup> This “dilemma” represents a distinct obstacle in situations where there is no third-party enforcement.<sup>207</sup> As Axelrod and Hamilton write in their ground-breaking paper “The Evolution of Cooperation”, “With two individuals destined never to meet again, the only strategy that can be called a solution to the game is to defect always despite the seemingly paradoxical outcome that both do worse than they could have had they cooperated.”<sup>208</sup> In the case of Prisoner Dilemma games “played only once, no strategy can invade the strategy of pure defection...in a single-shot Prisoner’s Dilemma, to defect always is an evolutionarily stable strategy.”<sup>209</sup> In an isolated interaction there is no escape from this.<sup>210</sup>

The well-known solution to this dilemma, of course, is to make the situation an iterated game.<sup>211</sup> Indeed, “[r]epeated interactions give rise to incentives that differ fundamentally from those of isolated interactions.”<sup>212</sup> Knowing that a greater benefit may be derived from future cycles of cooperation with the other party, agents have an incentive to forgo a short-term gain that may be achieved through defection. This in fact was the finding of Axelrod and Hamilton: cooperative strategies (of which, Tit-for-Tat is perhaps the best known) can emerge if the game comprises many periods of play, and parties expect their

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<sup>206</sup> See generally Axelrod, “The Evolution of Cooperation”, supra note 197.

<sup>207</sup> While a breakdown in a commercial relationship might not always result in a perfect Prisoner’s Dilemma situation (for example, in a one-shot game, defection may in fact yield a higher payoff than cooperation), here we employ Prisoners Dilemma as the archetypical example of a non-cooperation inducing game.

<sup>208</sup> Axelrod, “The Evolution of Cooperation”, supra note 197 at 1391.

<sup>209</sup> *Ibid.* at 1392.

<sup>210</sup> George J. Mailath, and Samuelson, Larry. *Repeated Games and Reputations: Long-Run Relationships* (Oxford: University Press, 2006) at 3.

<sup>211</sup> See generally Axelrod, “The Evolution of Cooperation”, supra note 197.

<sup>212</sup> George J. Mailath, and Larry Samuelson, *Repeated Games and Reputations: Long-Run Relationships* (Oxford: University Press, 2006) at 2.

current interaction will be but one incident in a series of future interactions.<sup>213</sup> After all, who would you be more inclined to trust: a mechanic fixing your car in a distant town you encountered while traveling, or the mechanic on the corner of your street, with whom you see and do business every day? This principle of permanence and duration has evolved to the point of an axiom among game theorists: “One-shot encounters encourage defection; frequent repetition encourages cooperation.”<sup>214</sup>

In the language of game theorists, as discount factors (the value placed on subsequent periods) increase and time horizons (the time of potential repeated interaction) broaden, a greater premium is placed upon maintaining a relationship of cooperation. The discount factor plays a pivotal role. The discount factor is a function of a player’s time preference and the probability of future interactions.<sup>215</sup> Situations “promoting a high probability of future interaction and low time preference are therefore more likely to induce optimizing equilibria. In the case of a one-shot game, on the other hand, the probability of future interaction is zero. So that the expected value of future cooperation is also zero.”<sup>216</sup>

This is precisely the dynamic we witness in commerce. Long-term contractual business relationships are grounded upon the prospect of continued future cooperation. Commercial interaction, in this sense, is an iterated game situation. The tendency to expand and increase the scope of these relationships with the same partners prevents a defection strategy from becoming dominant. As commercial relationships are essentially repeated games, parties with “selfish objectives might nevertheless behave cooperatively

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<sup>213</sup> Axelrod, “The Evolution of Cooperation”, *supra* note 197.

<sup>214</sup> M. Ridley, *The Origins of Virtue* (New York: Viking Penguin, 1996) at 65.

<sup>215</sup> Parisi, *Spontaneous Emergence Of Law: Customary Law*, *supra* note 68 at 607.

<sup>216</sup> *Ibid.* at 607. See also generally, Axelrod, “The Evolution of Cooperation”, *supra* note 197.

and efficiently...”<sup>217</sup> Certainly the trust that develops between two commercial parties is typically not trust in the generic sense, but rather, it is that both parties “trust” that the other party has determined that long-term future cooperation is in their own interest. As Axelrod points out, in commercial exchanges “business ethics are maintained by the knowledge that future interactions are likely to be affected by the outcome of the current exchange.”<sup>218</sup>

The inherent nature of commercial interaction is oriented towards repetition, and as such, is a process of iterated-game creation. Even in so-called one-shot game scenarios, there is often the potential for repetition underlying the interaction. For instance, a vendor may take responsibility for faulty merchandise if only to preserve the faint possibility of keeping a future customer. The dynamic of repeated dealings, or the potential for repeated interaction, will tend to produce cooperation strategies between parties. These may take many forms, and game theorists have exhibited no lack of creativity in conceiving of various strategies. Among them, however, the afore mentioned Tit-for-Tat strategy (hereafter called TFT) is perhaps the most well known. TFT is predicated upon repeated interaction.<sup>219</sup> As Ridley observes, “The principal condition required for Tit-for-Tat to work is a stable repetitive relationship. The more casual and opportunistic the encounters between a pair of individuals, the less likely it is that Tit-for-Tat will succeed

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<sup>217</sup> E. Maskin, “Evolution, Cooperation, and Repeated Games” (2007) No 80, Economics Working Papers from Institute for Advanced Study, School of Social Science, at 1.

<sup>218</sup> Axelrod, “The Emergence of Cooperation among Egoists”, *supra* note 197.

<sup>219</sup> A fascinating example of TFT that Ridley cites is that of soldiers on the Western Front in WWI. Truces were a common ‘problem’ between Allied and German units that had been facing one another for long periods of time and fought repeated battles over the same piece of territory. “Elaborate systems of communication developed to agree terms, apologize for accidental infractions and ensure relative peace—all without the knowledge of the high commands on each side...Raids and artillery barrages were used to punish the other side for defection...In order to eliminate these truces, commanders would frequently shuffle units about so “no regiment was opposite any other for long enough to build up a relationship of mutual cooperation. They would, in this way, stymie the cooperative-inducing effects of repeated interaction—a simple but effective ‘solution.’ M. Ridley, *The Origins of Virtue* (New York: Viking Penguin, 1996) at 65.

in building cooperation.”<sup>220</sup> Axelrod and Hamilton concluded that so long as players have a “sufficiently large probability” of meeting again, TFT can succeed.<sup>221</sup> A broader conception of the dynamic that underpins TFT is to term such strategies (including those that may not technically be TFT) as “conditionally cooperative.”<sup>222</sup>

The often-touted advantage of TFT is that it allows parties to penalize their partners while still leaving the door open to continued cooperation.<sup>223</sup> Certain elements of contracts are designed to achieve this very objective. For example, penalty clauses may be written into long-term contracts so as to provide a mechanism to redirect non-complying parties back into compliance, while preserving the agreement. Among other advantages to this, a party can avoid the transaction costs involved in finding a new commercial partner. This could be understood as “Tit-for-Tat with forgiveness” as it is termed in game theory circles.

Still, there are other elements of commercial law that allow individuals to employ harsher retaliatory strategies, such as grim-trigger, where a party will immediately terminate all future cooperation with a party upon the first sign of trouble. Certainly this is often the case with commercial interaction, where parties will not engage in future commercial dealings with individuals who did not honour agreements. Losing a client is precisely the commercial expression of a grim-trigger strategy. Grim-trigger is typically seen as an inferior strategy; however, the availability of competitors can make this strategy viable in a commercial setting—we could rename Grim-trigger “I’ll take my business elsewhere

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<sup>220</sup> M. Ridley, *The Origins of Virtue* (New York: Viking Penguin, 1996) at 63.

<sup>221</sup> Axelrod, “The Evolution of Cooperation”, *supra* note 197 at 1393.

<sup>222</sup> E. Maskin, “Evolution, Cooperation, and Repeated Games” (2007) No 80, Economics Working Papers from Institute for Advanced Study, School of Social Science, at 1.

<sup>223</sup> Ellickson, *Order Without Law*, *supra* note 199 at 164-165; Ridley, M. *The Origins of Virtue* (New York: Viking Penguin, 1996) at 60.

strategy.”<sup>224</sup> Benson, indeed, contends that competition can be understood as a “low-cost option to retribution or tit-for-tat sanctions.”<sup>225</sup>

The point to be understood here is that commercial interactions can be distinguished from non-commercial interactions in that they set out, and more clearly demarcate, a definite cycle of interaction. A contract can be understood as the creation of an iterated game. This sequence of “games” assists in the spontaneous development of voluntary cooperation strategies, thus getting around the need for third party enforcement.

In sum, when we speak here of high engagement we mean the extent to which individuals are involved with the relevant law—that they are engaged with it. This has two components, the first being integrally related to the second.

1. The *first* is the simple but profoundly important fact that in commercial interaction parties are engaged in the activity more; they simply do it more. They actively seek out interactions, repeat them more frequently (often with the same partners), and, for the most part, labour to expand their scope. This can be understood as repetition.

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<sup>224</sup> Another important point is the problem of the Folk Theorem in repeated games. The Folk Theorem of repeated games holds that “every intermediate possibility between full cooperation and full defection can occur in equilibrium as well.” (E. Maskin, “Evolution, Cooperation, and Repeated Games” (2007) No 80, Economics Working Papers from Institute for Advanced Study, School of Social Science, at 3.) The theory does not favour any one particular strategy over another; even some uncooperative strategies are equally as viable. Here the element of competition has an enormous impact. The Folk Theorem is applied to iterated games in which parties are locked into interaction. For the most part, this is not the case with commercial interaction, where parties can terminate a commercial relationship with a particular party if it is not proving beneficial. Fudenberg, D., and Maskin, E. “The Folk Theorem in Repeated Games With Discounting or With Incomplete Informatio.” (1986) 54 *Econometrica*. 533.

<sup>225</sup> Benson, “Economic Freedom and the Evolution of Law”, *supra* note 109 at 212.

2. The *second* point is intertwined with the fundamental nature of commerce, and one that greatly impacts on the first point. Commercial interaction is the act of actively doing something. The interaction is one that, unlike any other form of law, involves the creation of positive duties towards other individuals that call for the active and purposive attempt to meet these duties. Because of this, people are drawn into situations where they are highly engaged in the interaction. A commercial interaction represents a clearly delineated cycle of engagement—a “game.” Much more so than other areas of law, it is unique because people owe each other explicit duties, and this interaction may then repeated with profound repetition, constantly running through delineated cycles of interaction. Actively repeating these games breeds cooperation—a certain compliance with the norms that emerge even when it is not in a party’s immediate self-interest to do so. Repeated interaction offers a solution to social dilemma<sup>226</sup> problems. This is made possible by the fact that in commercial intercourse we have a well-defined sequence of interaction that may be repeated, and it is one that is actively performed.

So with commercial law we have a clear interaction that is repeated, and a kind of activity that is far more complex in that it involves the creation of new legal duties between individuals—iterated games. From this whirling pool of association, legal norms can emerge, gain momentum with each act of observance, and strengthen over time. There is no need for coercion; high engagement and an underlying recognition of reciprocity can,

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<sup>226</sup> A social dilemma a more broad term for situations that undermine cooperation. A social dilemma “exists when there is an incentive structure that leads individual actors to take a course of action that produces a collectively undesirable outcome.” Yamagishi, Toshio. “Seriousness of Social Dilemmas and the Provision of a Sanctioning System” 51 *Social Psychology Quarterly*. 32 at 32.

on their own, foster compliance. Towards this end, high engagement is critically important.

### 5.3 High Engagement and *Opinio juris sive necessitates*

In the absence of enforcement, reciprocity and a high level of engagement are enough to foster the emergence of what can be understood as legal norms. If not for the sheer frequency of interaction and thus exposure to these rules, behavioural conventions could not emerge without resort to the edicts of a central authority. It is precisely because the networks of commercial trade are coursing with a ceaseless flow of countless interactions repetitively occurring, that a well-define parameter of conduct can evolve—decentralized order can arise. It is as Cooter says, “a social network whose members develop relationships with each other through repeated interactions.”<sup>227</sup> From this stream of interactions the formative element in customary law identified by the phrase *Opinio juris sive necessitates* emerges; that is, the widespread conviction that the practice represents a kind of essential social norm.<sup>228</sup> The perception of this obligatory nature of a social norm is crucial in non-enforcement systems (and perhaps in all systems of regulation) because it is here that we find the basic foundations upon which a system of spontaneous compliance evolves. Through repeated exposure to a particular rule that confers an obvious reciprocal advantage, participants begin to ‘internalize’ the norm.<sup>229</sup> Fon and Parisi note that “internalization of [a] norm is a source of spontaneous compliance... individuals internalize obligations when they disapprove and sanction other

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<sup>227</sup> Cooter, “Structural Adjudication and the New Law Merchant: A Model of Decentralised Law”, *supra* note 201 at 216.

<sup>228</sup> Literally: “opinion of law but of necessity.” It is defined as, “Opinio juris sive necessitatis or Opinio juris is the belief that a behavior was done because it was a legal obligation. This is in contrast to a behavior being the result of different cognitive reaction, or behaviors that were habitual to the individual.” Health Dictionary and Research Guide, online: <<http://www.123exp-health.com/t/01081120472/>>.

<sup>229</sup> A good example of internalisation would be a driver stopping at a red light in the dead of night on a deserted intersection although he is sure he could flout the law without repercussions.

individuals' deviation from the rule, or when they directly lose utility when the norm is violated."<sup>230</sup>

The lack of coherent rules undermines the ability of a trading community to develop, with the direct consequence that participants lose utility to the extent that the flow of commerce is impeded.<sup>231</sup> In this way, the process of internalization is kick-started. Looking at some aspects of business usages, one might hesitate to call these rules law with a capital "L." Arguably, these rules, however, are precisely that; they are the nascent emergence of norms yet hardened into codified law but every bit as binding upon those who voluntarily participate in the affected system. They are examples of horizontal law, as Fuller would call it.<sup>232</sup> And it is only within a system that exhibits such a level of high engagement in terms of sheer repetition and discrete cycles of interaction that this form of customary law can evolve so vividly. Without the energizing milieu of high engagement in the form of repeated exposure and participation in these norms, such conventions would not have the fertile soil in which to firmly take root.

Thus, engagement is absolutely crucial. On a very frequent basis, communities of merchants and traders are involved in a highly specialized set of relationships as they aggressively pursue trade with one another. The simple fact that they are so involved fosters a clear recognition of rules. It is not necessary that any one authority formulate these rules; the community itself, through the generative process of repeated interaction,

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<sup>230</sup> Fon and Parisi, "Role-Reversibility, Stochastic Ignorance, and the Social Cooperation", *supra* note 178 at 5.

<sup>231</sup> Or as a "local public good" as Cooter would identify it as he does in fleshing out his alignment theorem. Cooter, "Structural Adjudication and the New Law Merchant: A Model of Decentralised Law", *supra* note 201 at 224.

<sup>232</sup> See *supra* note 85.

can produce clear legal norms. It is the high level of engagement that is key here. High engagement and reciprocity work in tandem to produce identifiable norms and the subsequent adherence to them.

## Part II

### The Element Of High Engagement: Natural Selection, Path Dependency, and the Evolution of Norms

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Before we continue, a short review of what was presented in the first half of this paper might be of some use. We briefly discussed the idea that systems of commercial law may evolve spontaneously in response to market forces, and that such systems may function in the absence of a central authority. In lieu of external coercion, the incentive of reciprocal gain implicit in commerce and the potential loss of it encourages compliance. Thus, reciprocity is of paramount importance to systems where there is no overarching authority standing by to enforce the rules of the game. Indeed, the players themselves create, and acquiesce to the rules, precisely because they derive some overall comparative advantage in continuing to play the game. To this end, what we have awkwardly termed “high engagement” is absolutely critical in the development of such systems of law. This element of engagement—which we divided into that of repetition and game creation—is critical because it has important implications regarding: *first*, commercial law’s ability to spontaneously forge new legal norms, and *secondly*, participants’ subsequent compliance with those norms.

We have, however, yet to explore in a systematic fashion, how exactly high engagement induces the evolution of substantive norms and compliance where there is no exogenous coercion. What follows is precisely that. The remainder of this paper will discuss how high engagement induces the evolution of norms, as well as compliance with these norms in the absence of external enforcement.

## 6. Norm Creation, Repetition and the Natural Selection of Commercial Law

If a central legislating authority is removed from the equation, the question arises: how can legal norms still evolve? To rephrase the question: without a “lawmaker”, how is law made? As we will see, the element of repeated interactions here is key. According to the perspective most associated with Thomas Hobbes, human society requires a coercive authority to enforce systems of cooperation; without the machinery of the state, the argument goes, the perennial temptation to free-ride will undermine such a system.<sup>233</sup> Indeed, the work of the new norms scholars of the “New Chicago School” reflect the same sentiment in their call for “governmental intervention to manipulate the norm-making process.”<sup>234</sup>

For Kelsen, a pure positivist, legal norms are created by acts of will and no more.<sup>235</sup> In Kelsen’s pure theory of law, the imposition of sanctions is contingent upon what he concludes is a hierarchy of norms; a cascading succession of norms deriving their validity from a preceding and more generalized norm, at its apex, a *grundnorm*, a basic norm, which serves as a bedrock from which subsequent, more precise norms emerge. This process of norm evolution, Kelsen terms *concretization*, since each step comprises a norm that is more precise and concrete than the previous one.<sup>236</sup> A norm’s validity is a result of it being a member in this larger system of norms. The *grundnorm*, however, lies at its root; it is “the basic norm that constitutes the unity in the multitude of norms by

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<sup>233</sup> R.C. Ellickson, “The Market for Social Norms” (2001) 3 American Law and Economics Review. 1 at 3.

<sup>234</sup> *Ibid.* at 4.

<sup>235</sup> Harris, J. W.. *Legal Philosophies*. Second Edition (London: Redwood Books, 1997) at 67. See also generally Hans Kelson, *General Theory of Law and State* (Cambridge: Harvard University Press, 1945); Hans Kelsen, *General Theory of Norms* (Oxford: Clarendon Press, 1991).

<sup>236</sup> Kelsen also calls this evolution *individualization*. For detailed exposition of the idea of *concretisation* see Hans Kelson, *General Theory of Law and State* (Cambridge: Harvard University Press, 1945) at 134-35.

representing the reason for the validity of all norms that belong to this order.”<sup>237</sup> The basic norm is not a product of norm creation but is a core belief of anyone who subscribes to the law. Thus, for example, if Kelsen is speaking of American law, this would be the U.S. constitution in that it confers legislative authority onto the congress.<sup>238</sup> At its core, however, it is a ‘fiction’ that is no more than “a cognitive device used when one is unable to attain one’s cognitive goal with the material at hand.”<sup>239</sup> Upon this ‘fiction’, the legitimacy of sanctions is predicated, and thus norms ultimately derive their validity, rendering the normativity of law intelligible.<sup>240</sup>

However, the stance of Libertarian theorists such as Hayek and Benson, offers up an alternative explanation of how norms may emerge. They argue that rules of governance may evolve as the unintended outcome of individuals separately pursuing their interests—the same as markets do.<sup>241</sup> In this sense, then, the pursuit of self-interest may be said to serve as a Kelsenian *grundnorm*—the ‘fiction’ that self-interest creates an ‘ought.’ While there is no central authority to create law, the participants themselves, through their very participation, generate the relevant legal norms. Rules evolve spontaneously from the vast flow of voluntary interaction, as “individuals discover that the actions they are intended to coordinate are performed more effectively under one

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<sup>237</sup> Kelsen, Hans. *Pure Theory of Law* trans. by Max Knight (Berkeley: University of California Press, 1967) at 1.

<sup>238</sup> Kelsen writes, “If the historically first constitution was posited by the resolution of an assembly, then it is the individuals forming this assembly who are empowered by the basic norm; if the historically first constitution arose by way of custom, then it is this custom, or to be more exact, it is the individuals whose behaviour forms the custom creating the historically first constitution, who were empowered by the basic norm.” Hans Kelsen, *General Theory of Norms* (Oxford: Clarendon Press, 1991) at 255.

<sup>239</sup> *Ibid.* at 256.

<sup>240</sup> Kelsen, Hans. *Pure Theory of Law* trans. by Max Knight (Berkeley: University of California Press, 1967) at 201.

<sup>241</sup> Benson, “Economic Freedom and the Evolution of Law”, *supra* note 109 at 209.

system or process than under another.”<sup>242</sup> Through a slow progression of trial and error, duplication and emulation, successful rules are modified and employed again in subsequent interactions. Over time, better rules tend to replace less effective ones. Thus, through a winnowing process, rules and institutions are “naturally selected” and proliferate in use precisely because they prove themselves to be the most efficient.<sup>243</sup>

In this way then, rules evolve slowly over time, emerging incrementally from repeated interactions. And it is here that the element of high engagement is so important. As we have discussed, commercial law demonstrates a markedly higher degree of repeated cycles of interaction. Without this constant flow of repeated dealings, norms could not emerge in this manner. To this end, game creation and repetition is crucial.

## **6.1 Not of Human Design: Legal Norms as an Aggregate of Individuals**

### **Separately Pursuing their Interests**

Hayek contends that there exist orderly structures, which are “the product of the action of many men but are not the result of human design.”<sup>244</sup> This oft-referenced quote by Hayek sums up the crux of the position quite nicely. Efficient systems of order can evolve incrementally from a steady flow of countless small occurrences, each one, not necessarily meant to achieve the final product. The process is “independent of any common purpose, which the individual need not even know.”<sup>245</sup> It is possible for commercial rules to evolve in such a manner.<sup>246</sup>

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<sup>242</sup> Benson, “Economic Freedom and the Evolution of Law”, *supra* note 109 at 209.

<sup>243</sup> *Ibid.*

<sup>244</sup> Hayek, *Law, Legislation, and Liberty*, *supra* note 7 at 37. See also Hayek, F.A., *Studies in Philosophy, Politics and Economics* (Chicago: University of Chicago Press, 1967) at 77.

<sup>245</sup> Hayek, *Law, Legislation, and Liberty*, *supra* note 7 at 50.

<sup>246</sup> Indeed, the evolution of the Medieval Law Merchant, in many respects, exemplifies this process. Benson argues that the rules of the Law Merchant evolved in this manner. Benson, “The Spontaneous Evolution of

In each occurrence, the actors are driven merely by the pursuit of their own interests, that is, the acquisition of reciprocal benefit. The rules that are formulated are created only to meet the immediate ends of the specific interaction in which they are involved; but from this a greater system of rules will evolve. It is, in this way, very much like the principle that drives the exchange process: “the order of the market rests not on a common purpose but on reciprocity; that is, on the reconciliation of different purposes for the mutual benefit of the participants.”<sup>247</sup> Here we see again how commercial law is analogous to “spontaneous market equilibria,”<sup>248</sup> evolving in relation to commercial forces. Coordinated in this fashion by the guiding principle of reciprocal benefit, there emerges a tendency towards an overall equilibrium regarding the actions of individuals.<sup>249</sup> However, the greater system of legal norms is not the product of any grand design as would be the case (at least in theory) with government codification; it is rather the outcome of countless tiny interactions—a slow trickle-like build up of norms from the unintended outcome of individuals separately pursuing their interests.

This is particularly true in the case of commercial intercourse; each isolated interaction, each exchange guided by the clear pursuit of individual gain, contributes to the blind articulation of an overall coherent body of rules. As is noted by Parisi, this formulation “proceeds through a purely inductive accounting of subjective preferences. Through his own action, each individual contributes to the creation of law. The emerging rule thus

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Commercial Law”, *supra* note 5. See also above chp 3.5: Spontaneous Legal Evolution and the Law Merchant.

<sup>247</sup> Hayek, *Law, Legislation, and Liberty*, *supra* note 7 at 109-110.

<sup>248</sup> Parisi, Spontaneous Emergence Of Law: Customary Law”, *supra* note 68 at 612.

<sup>249</sup> See Hayek's "Competition as a Discovery Procedure" (1978) *New Studies in Philosophy, Politics, Economics and the History of Ideas*. 179.

embodies the aggregate effects of independent choices by various individuals that participate in its formation.”<sup>250</sup>

## **6.2 Making Law Through Contract: Norm Tweaking**

Parisi is here referring to all forms of customary law. However, this process is especially salient in commerce. Why? Commercial interaction is so much more fertile soil for this process primarily because the parties themselves are in a position to tweak the law. The nature of contract is one that allows for the formulation of new terms and conditions that will, with repeated use, mature into legal norms. As Parisi also notes, “This process allows individuals to reveal their preferences through their own action, without the interface of third-party decision makers.”<sup>251</sup> From this succession of interactions, the law is incrementally adjusted through a process of “norm tweaking.”

This is nowhere more true than in the realm of contract, where parties can actually draw up the rules that will govern their interactions. Fuller actually defined contract law as an explicit form of law fashioned through an explicit process of bargaining.<sup>252</sup> Indeed, “The parties who negotiate such law are a kind of miniature legislature, and their law a miniature statute.”<sup>253</sup> Through the synergetic process of contract, participants cast their vote on what they have concluded is the most efficient rule regarding their specific situation. A continual “referendum” on rules is taking place with each interaction. This is profoundly different from other forms of law derived solely from legislation. In such

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<sup>250</sup> Parisi, Spontaneous Emergence Of Law: Customary Law”, *supra* note 68 at 612.

<sup>251</sup> *Ibid.*

<sup>252</sup> See Lon L. Fuller, *The Principles of Social Order: Selected essays of Lon L. Fuller*. Edited by Kenneth I. Winston (Durham: Duke University Press, 1981) at 169-187.

<sup>253</sup> Robert S. Summers, *Lon L. Fuller, Jurists: Profiles in Legal Theory* (London: Edward Arnold, 1984) at 81.

cases, there is no means for participants to directly and plainly signal perceived shortcomings in the law; there is no opportunity to tweak and refine the law. Through contract, commercial law gives voice to the actual participants. The merchants themselves “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.”<sup>254</sup> Thus a situation emerges in which the law may be continually refined.

As Benson explains

The commercial sector continues to develop an expanding base of customary law. Order clearly arises from contractual agreements, for instance. Thus, contracts negotiated and voluntarily entered into by private individuals provide one form of privately created law...if a contract develops an effective new business practice in the face of a new situation, it is likely to add to customary law. Since commerce operates in a dynamic continually changing environment, new contractual arrangements are always being mediated—new law is being created.<sup>255</sup>

This body of law “grows, it does not change in the sense that an old law is suddenly overturned and replaced by a new law. That growth tends to be gradual but fairly continuous, through spontaneous collaboration.”<sup>256</sup>

### **6.3 Norms are Reviewed in Situations of Success as well as Failure**

It is important to note how much this differs from other forms of law. In non-commercial forms of law, the efficacy of the law is examined only in cases where the law has essentially failed, and as a consequence, has given rise to litigation.<sup>257</sup> Litigation alone (and actual legislation) provides the only occasion for possible amendments to the law (in

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<sup>254</sup> Trakman, Leon E. *The Law Merchant: The Evolution of Commercial Law* (New York: Fred B Rothman & Co, 1983) at 1.

<sup>255</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 658.

<sup>256</sup> *Ibid.* at 660.

<sup>257</sup> Georg von Wangenheim, “Where Do We Stand? Where Should We Go?” University of Kassel, working paper, at 3.

civil law systems, this is restricted to only legislation). Rubin and Priest point out that legal rules will only be challenged in court if they prove to be inefficient.<sup>258</sup> Leoni argues that “individuals make law, insofar as they make successful claims.”<sup>259</sup> Such is the case with most forms of law. Review is limited to situations of actual litigation, when official attention is drawn to the inadequacy of the law highlighted by its own failure.

This is not so with commercial law. Commercial law is subject to immediate review in each and every interaction regardless, precisely because the participants themselves are actively engaged in, if you will, “tuning” the law. Thus, the efficiency of a rule is not only evaluated in cases where it has failed (this can be in the case of formal litigation or simply by the parties themselves if no litigation is initiated), but equally in cases where it has “succeeded.” In this way, the efficiency of a commercial rule is scrutinized in situations where it fails as well as in situations where in place of outright failure, the law merely portrays a slight degree of inefficiency. Insofar as non-commercial law goes, situations where the law does not fail to the point of giving rise to actual litigation, but nevertheless lacks the comparable efficiency of alternative rules, the law in question will not have the occasion to be modified. This is the inherent advantage of decentralized rule making: it can be continually tweaked because those who directly engage in the regulated activity are in a position to fine-tune the rules, either through direct modification or through the selection of alternative rules to govern their future dealings. Indeed, Fuller

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<sup>258</sup> Their purpose in making this point is to argue that this tendency will induce efficiency in the common law. However, for our purposes, the point to be noted is that the only occasion for inefficient laws to be modified is through actual litigation. Paul H. Rubin, “Why is the Common Law Efficient?” (1977) 6 *Journal of Legal Studies*. 51; George L. Priest, “The Common Law Process and the Selection of Efficient Rules” (1977) 6 *Journal of Legal Studies*. 65.

<sup>259</sup> Bruno Leoni, “The law as Individual Claim”, developed from lectures given at the Freedom School Phrontistery in Colorado Springs, Colorado, December 2-6, 1963; reprinted in Bruno Leoni, *Freedom And The Law* (Indianapolis: Liberty Fund, 1991) 189 at 202.

among others, recognized this advantage in customary law, citing how spontaneously evolved rules emerge through “dispute arbitration and adjudication combined with the spread of superior ways of doing things through competition and imitation...”<sup>260</sup>

Contract law is unique in that it allows for a more active role in its actual formulation. The parties of the contract are their own “miniature legislature” judging the efficiency of their contractual arrangement through the very commercial interaction they undertake. The rules that govern their dealings are constantly being evaluated in terms of its ability to achieve varying levels of efficiency. In this way, traces of inefficiency can be addressed; in subsequent dealings rules that prove even slightly impractical can be jettisoned and more efficient rules may be adopted in their place. With each new interaction, players can engage in a process of “norm tweaking.” This has the ultimate effect of making commercial law far more amenable to a kind of incremental evolution that incorporates a natural selection-like process, similar to that found in biology.

#### **1.4 Law Evolves Towards Efficiency**

This body of law continually evolves through a process of natural selection towards ever-greater efficiency. Through their participation, actors refine the rules that oversee their commercial arrangements. Pragmatism and meeting the requirements of the market is the guiding spirit of such reform. Hayek contends that such a process generally produces an optimal system of rules, which could not be achieved through any planned scheme.<sup>261</sup> Hayek asserts that “a spontaneous system of rules will be more efficient...precisely because it has survived an evolutionary process: a process in which not reason but

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<sup>260</sup> Barry Macleod-Cullinane, “Lon L. Fuller And The Enterprise Of Law” (1995) 22 Legal Notes 1995. 1 at 1.

<sup>261</sup> Barry Norman, “The Tradition of Spontaneous Order” (1982) 5 Literature of Liberty. at 29.

*natural selection* determines which rules and institutions are appropriate.”<sup>262</sup> This is a central argument of Hayek’s: order that evolves spontaneously from a decentralized process can achieve a greater degree of efficiency,<sup>263</sup> and as we discussed earlier, this notion arguably lies embedded within the theoretical underpinnings of the common law.<sup>264</sup> As Ellickson notes, social norms that evolve “...through natural selection tend to be wiser than the ratiocinated policies of the most brilliant policy makers.”<sup>265</sup>

The decentralized process of norm formation in commercial systems is comparable to any other decentralized market process.<sup>266</sup> Thus, just as decentralized market processes have “a comparative advantage over centralized allocation mechanisms in the creation of efficient equilibria”,<sup>267</sup> so too does a decentralized process of norm formation arising in response to the same commercial forces that drive the market. Such a process is analogous to a decentralized decision making process, possessing a certain advantage over centralized processes in generating efficient rules.<sup>268</sup> Thus, in this manner, a process of natural selection refines the rules of commerce towards greater and greater efficiency.

## 6.5 Competition Breeds Efficiency

The nature of commerce is very receptive to an evolution of this sort. The market itself provides an exceptionally accurate mechanism with which to gauge the ‘effectiveness’ of

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<sup>262</sup> *Ibid.*

<sup>263</sup> Hayek, F.A. *The Constitution of Liberty* (Chicago: University of Chicago Press, 1960) at 58-61.

Hayek’s “claim is that greater regularity and predictability, and therefore complexity, will exist in orders where the bulk of the rules that govern interdependency have emerged spontaneously.” From this Hayek goes onto conclude that a greater degree of efficiency may be achieved. Barry Norman, “The Tradition of Spontaneous Order” (1982) 5 *Literature of Liberty*. at 29.

<sup>264</sup> See above chp. 3.2 Early Traces of Spontaneous Law Theory.

<sup>265</sup> R.C. Ellickson, “The Market for Social Norms” (2001) 3 *American Law and Economics Review*. 1 at 4.

<sup>266</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 645. See also above chp. 3.4: Understanding Commercial law as an invisible hand.

<sup>267</sup> Parisi, *Spontaneous Emergence Of Law: Customary Law*”, *supra* note 68 at 611.

<sup>268</sup> *Ibid.*

these rules. Commercial efficiency is the sole measure of any rules. Thus, rules that do not prove to be the most effective are quickly discarded and replaced by more efficient ones. The element of competition, implicit in commercial enterprise, ensures this. In order to remain competitive, those engaged in commerce must adopt more efficient rules to oversee their interactions. To not do so, would imperil their competitive position, and ultimately their commercial survival. Thus, it is not even really a question of choice; driven by competition, actors are often forced to implement commercial laws that have proven most functionally efficient. As with natural selection in the biological world, those who do not remain competitive simply do not survive. Those who developed better rules and thus reinforced their capacity to successfully trade were able to flourish, and with them, the rules they chose to institute. In this sense, competition breeds efficiency. Non-commercial law is not predicated upon competition. Thus, there is no comparable imperative to improve upon less than optimally efficient norms. Evolutionary traps may emerge.<sup>269</sup> A coercive authority is thus needed to institute and enforce changes in law, and knock it back on a more collectively beneficial track. In contrast, commerce, with its unforgiving bottom line and its twin gods of profit and loss, confers survival only to the fittest.

What is true for individual actors within commerce is also true for entire systems of commercial law. New rules and institutions that prove more efficient will be adopted by groups of actors so long as transaction costs do not thwart this process.<sup>270</sup> As a result, “more effective rules and institutional arrangements tend to replace less effective ones as

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<sup>269</sup> An evolutionary trap is situation where the benefit pursued by each individual is not sufficient to compensate for the harm incurred by other member in the group, generating a suboptimal Nash equilibria. In such cases, the system is not self-correcting, and as a consequence, will continue along this less than efficient path. Parisi, *Spontaneous Emergence Of Law: Customary Law*”, *supra* note 68 at 616.

<sup>270</sup> Benson, “Economic Freedom and the Evolution of Law”, *supra* note 109 at 209.

individuals observe, learn, imitate, and secede in order to migrate when superior competitive alternatives are available.”<sup>271</sup> Indeed, as we have seen, the primary catalyst for the emergence of the Medieval Law Merchant was in fact that it was a more commercially efficient system of law.<sup>272</sup> In a modern context, jurisdictional ‘shopping’ embodies this phenomenon. Parties will tend to choose the jurisdiction that proves least disruptive to their commercial interests (this is treated in greater detail below).

### **6.6 The Importance of High Engagement: Each Repeated Interaction is a Test-Run**

What is true for the theory of natural selection in the realm of biology is also true for this evolutionary process of “norm tweaking.” For such a complex system to emerge in this incremental fashion, it is paramount that we are dealing with a vast multitude of interactions. Each successive interaction builds on the one before it. It is a process of repeated refinement and improvement. To this end, high engagement plays a decisive role. The higher the level of engagement, the more easily norms may evolve in this fashion.

Central to this evolutionary process is the ability for rules to be repeatedly evaluated and then modified. Commerce is precisely such a situation. Each commercial interaction represents a discrete test of the efficiency of a given rule. The interaction itself is an ideal platform from which to evaluate the worth of a particular rule; the relative success or failure of the commercial interaction itself serves as a precise measurement of the rule’s efficiency. Each commercial dealing then is, in a sense, a test run of the rule’s

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<sup>271</sup> *Ibid.*

<sup>272</sup> See also above chp. 3.4: Spontaneous Legal Evolution and the Law Merchant.

effectiveness performed by the parties in the best position to most accurately appraise the practical impact of the rule upon the interaction.

Through subsequent contract formation, this evaluation can immediately translate into a change in the rules. Thus, the process of constant and repeated “norm tweaking” is instrumental in this evolution. And towards this end, repeating these appraisals in the form of frequent commercial dealings is essential—the more it is repeated, the more powerfully this process can occur.

### **6.7 Discrete Cycles of Interaction are Important as Feedback Loops**

Because commerce entails a higher level of engagement, in which players repeat these interactions, commerce creates a constant flow of independent “test-runs.” A singular interaction from within the incessant succession of interactions which is commerce, forms a complete test cycle through which a given rule can be evaluated. It is one small juncture in a long sequence of evolution comprising a myriad of minute interactions. For there to be incremental feedback at discrete stages along the way, there must be these complete cycles of interactions through which a rule can be in effect tested, and the results fed back into the system. Thus, forming these discrete cycles at various stages is crucial to an evolutionary process. This is not so with other forms of law. Because, non-commercial forms of law generally do not consist of a concrete series of actions, no definite cycle of interaction is formed. Further, these interactions are not repeated with the same frequency.

As in evolutionary biology, where more efficient traits become more common in successive generations of a population as each organism reproduces, in the process of legal natural selection, more efficient rules will thrive in the form of new interactions that employ the rule. The repetition of a singular and distinct commercial interaction is comparable to an organism reproducing in the field of biology. Indeed, as we discussed, successful commercial ventures will in fact lead to a repetition of the same interaction, often with increasing frequency. This is in fact often the overarching objective to the interaction—reproducing it. More efficient rules ensure the success of an interaction, which in turn may then be repeated.

### **6.8 Norm Diffusion**

High engagement also has the effect of spreading norms between groups. Successful players will often seek out new partners with which to forge new business relationships, in an effort to duplicate their prior successes and expand their pool of wealth. Thus, as within the realm of biology, efficient rules will spread by way of this mixing—something akin to the spreading of an advantageous gene pool.

In other forms of law, we do not find a comparable fluid mixing of specific, targeted partners. This has a large part to do with the fact that commercial law is, as we have already mentioned, unique in that it requires the seeking out of explicit partners with whom to establish a definite relationship, and engage in a clear delineated cycle of interaction, i.e. business. Other forms of law are not so much to do with the building of partnerships, as they are concerned with preventing injurious interactions between

individuals in a large group. Again, here we have the idea that commercial law is the active formation of new relationships of cooperation between select parties, while non-commercial law involves the regulating of the behaviour of individuals through injunctions, that is, what not to do. Thus, the former will force a mixing of players by linking together individuals, producing a greater diffusion of norms.

While forms of association regulated by non-commercial law are generally static, commercial interactions, in contrast, are highly specialized, active, and marked by a tendency to build fresh relationships with new partners. Although I share a fleeting legal relationship with the man I pass on the street in that we both obey the law, mutually refraining from inflicting harm on one another (hopefully), we do not construct a specialized form of association, and, more importantly, nor do I actively seek out new people to pass on the street. In this sense, these relationships can be understood as generally static. Commerce, in contrast, is a bridge between particular parties within a greater community. Perhaps it could be conceptualized in this manner: while non-commercial law regulates interactions between individuals in “a large and at times somewhat unclearly defined community,”<sup>273</sup> commercial interaction is in effect the constructing of a miniature community within the larger community, one sometimes involving only two parties (if this can rightly be called a community). It constructs a clear, dynamic relationship between them. Thus, this “bridge” created between one set of people, can then be extended to another, and so forth. In each instance, a smaller “community” is carved out from the greater whole—the result being a greater diffusion of norms as norms are carried from one “community” to the next.

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<sup>273</sup> Lon L. Fuller, *The Principles of Social Order: Selected essays of Lon L. Fuller*. Edited by Kenneth I. Winston (Durham: Duke University Press, 1981) at 227.

And this applies equally to entire regions; this mixing often reaches across the threshold of national and cultural borders, as the long arm of commerce extends to wherever it can seize hold of a business opportunity and flourish. Thus, the nature of commerce, in that it constructs new and specialized forms of association between definite parties, in the process, facilitating a diffusion of proven efficient rules that are instituted to oversee these interactions. The element of high engagement when it is pronounced within a system is thus instrumental in aiding the evolution of norms through a process of natural selection. High engagement, however, has other effects as well.

## 7. Path dependency of Legal Norms in Commercial Law, Bandwagon and Network effect

Arguably, there is a certain path dependency to this whole process.<sup>274</sup> Recall the idea that systems of commercial law may evolve very much like markets do. As we have seen, Benson contends that Commercial law should be conceptualized as an instrument of the market, facilitating interaction and making exchange more efficient.<sup>275</sup> In this view, the rules that evolve do so in response to the decentralized coordination of the market. Continuing then with the idea of commercial law as a product of market forces, let us examine in brief a concept drawn from the field of economics that may account for how certain commercial products proliferate in use in a path dependent manner.<sup>276</sup> Migrating from the domain of economic theory, the notion of network externalities,<sup>277</sup> or network effect (also called external increasing returns) has been put forward as a way of explaining the ascendancy of particular products over others.<sup>278</sup>

If commercial legal norms indeed evolve in response to the market, then it stands to reason that they may be equally predisposed to the effects of network externalities. That

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<sup>274</sup> Benson, “Economic Freedom and the Evolution of Law”, *supra* note 109 at 209.

<sup>275</sup> See above chp. 3.4: *Understanding Commercial law as an invisible hand*.

<sup>276</sup> For how the concept of network effect has been applied in the literature of path dependence see: W. Brian Arthur, “Competing technologies, increasing returns, and lock-in by historical events” (1989) 99 *Economic Journal*. 116; W. Brian Arthur, “Positive feedbacks in the economy” (1990) 262 *Scientific American*. 92; David, *supra* note 286; Liebowitz, S. J. and Margolis, S. E.. “Path dependence, lock-in and history” (1995) 11 *Journal of Law, Economics and Organization*. 205.

<sup>277</sup> Network effects are considered network externalities if participants in the market fail to internalize these effects. (S. J. Liebowitz, and Stephen E. Margolis “Network Externalities (Effects)” Management School, University of Texas at Dallas. at 1). However, we use both terms here more or less interchangeably, as the points made here should apply to some extent to situations even where actors have not internalized the effects. For our purposes, the distinction is not so pertinent.

<sup>278</sup> The phenomenon was observed by early economists such as Alfred Marshall and Adam Smith (Smith noted that certain businesses tend to congregate geographically, attracting customers to that particular location, which in turn attracts more businesses to move to the location). In the 1980s and 1990s, this idea was reintroduced into mainstream economics by scholars such as Arthur, David, and Krugman. See W. Brian Arthur, *Increasing Returns and Path Dependence in the Economy* (Ann Arbor, University of Michigan Press, 1994); David, *supra* note 286; Paul R. Krugman, *Peddling Prosperity: Economic Sense And Nonsense In The Age Of Diminishing Expectations* (New York: W. W. Norton & Company, 1995).

is, if we accept that norms emerge in coordination with the needs of the market, comparable to how products do, the concept of network effect can similarly be applied to the growth of legal norms within the realm of commercial law. The spread of business usages, standard terms of contract, rules of arbitration, and even entire legal systems, in short, all the elements of the modern law merchant, may be attributed, in some measure, to the effects of network externalities. This is what we will attempt to do in this section, looking closely at how high engagement promotes this effect. The principle of network externalities can shed much light upon how norms evolve as a consequence of commercial interaction. Arguably, the element of high engagement makes commercial law particularly inclined to the effects of network externalities. The discussion that follows will only briefly lay out the bare bones of the idea, though the topic is deserving of a far more in-depth discussion than can be presented here.

### **7.1 So what is Network Effect?**

The principle of network effect, or the closely associated concept bandwagon,<sup>279</sup> is basically the idea that the implicit value of a certain product derived by an agent increases as the number of other agents using the same product grows.<sup>280</sup> For example, your fax machine will increase in value to you as more consumers also purchase fax machines. Obviously, if only you owned a fax machine, its utility would be limited to that of a large paperweight. Thus, "the utility that a given user derives from the good depends upon the

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<sup>279</sup> The Bandwagon principle is in fact more accurately understood as one result of Network Effect.

<sup>280</sup> S. J. Liebowitz, and Stephen E. Margolis "Network Externalities (Effects)" Management School, University of Texas at Dallas. at 1; See also Katz and Shapiro's 1985 paper on network externality in the *American Economic Review* where they define network effect thusly: "There are many products for which the utility that a user derives from consumption of the good increases with the number of other agents consuming the good." M. L., Katz and Shapiro C. "Network externalities, competition, and compatibility" (1985) 75 *American Economic Review*. 424 [Katz and Shapiro, "Network externalities, competition, and compatibility"]

number of other users who are in the same 'network'...”<sup>281</sup> As more users begin to use the product, and thus its utility grows, more consumers begin using the product, and on it goes, creating a kind of snowball effect as more and more users jump on the bandwagon (hence the term ‘bandwagon’). Positive feedback mechanisms like bandwagon and network effect lie at the heart of path dependency; such mechanisms reinforce burgeoning patterns in a particular field, causing these patterns to become progressively more entrenched. There is in fact a fascinating conversation going on in the literature regarding the possible negative effects of such phenomenon in terms of natural monopolies and the emergence of inefficient standards—that, however, lies just slightly outside the scope of the present discussion.<sup>282</sup>

A popular real-world example of network effect is the predominance of VHS format over its rival Beta in the early 1980s as video recording became popularized. It has been argued that as more consumers bought VHS players, videocassette rental stores observing this trend, stocked up on VHS videocassettes, which in turn caused more people to opt for VHS players over Beta, ultimately leading to complete vendor lock-in.<sup>283</sup> Manufacturers, predicting that VHS would win this standardization war, began to produce even more VHS players as a result (an example of bandwagon).<sup>284</sup> By 1984, VHS videocassettes

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<sup>281</sup> *Ibid.*

<sup>282</sup> Liebowitz, and Margolis, for one, examine what they call “third degree” path dependency in which standards are locked in an inefficient trajectory because participants cannot coordinate and switch to more efficient standards en masse. They conclude that, although rare, third degree path dependence has “significant normative policy implications, as it would constitute economic efficiency.” See S. J. Liebowitz, and Stephen E. Margolis, “Market processes and the selection of standards” (1996) 9 *Harvard Journal of Law and Technology*. 283 at 289. See also generally W. Brian Arthur, “Positive feedbacks in the economy” (1990) 262 *Scientific American*. 92 at 92, 99.

<sup>283</sup> The idea of vendor lock-in, or customer lock-in, also known as proprietary lock-in, occurs when a customer becomes dependent a vendor’s products or services, unable to switch to an alternative vendor due to high switching costs.

<sup>284</sup> Liebowitz, and Margolis, however, dispute the veracity of this argument (as they also do with the QWERTY keyboard example), citing other possible factors that may have led to VHS dominance in the market. See S. J. Liebowitz, and Stephen E. Margolis, “Market processes and the selection of standards”

became the standard format for videocassettes, with every manufacturer in the industry (with the exception of Sony) adopting the VHS format.<sup>285</sup>

Another oft-cited illustration, first pointed out by David,<sup>286</sup> is the use of the QWERTY keyboard as a standard layout for keyboards.<sup>287</sup> Alternative layouts for keyboards are arguably more efficient.<sup>288</sup> In fact, the QWERTY layout was originally designed so as to slow down typing speed in an effort to prevent jamming of the keys on old-fashioned mechanisms.<sup>289</sup> As more and more typist became trained in typing on the QWERTY design, manufacturers increasingly produced the QWERTY keyboard, which in turn encouraged more people to learn to type using this particular design of keyboard. The more common the QWERTY keyboard was, the more valuable it was to learn to type on keyboards of that design. And there we have it, network effect—the process reinforces itself. This is a good example of network effect because for one trained in typing on a QWERTY keyboard, the value of the skill, and thus owning a QWERTY keyboard, increased in relation to how many QWERTY keyboards were in use. This was due to the value of the "network" of such keyboards. This is often pointed to as a definitive illustration of increasing returns path dependence.<sup>290</sup> Still, beyond VHS and QWERTY

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(1996) 9 *Harvard Journal of Law and Technology*. 283 at 312-316; see generally S. J. Liebowitz, and Stephen E. Margolis "The fable of the keys." (1990) 33 *Journal of Law and Economics*. 1 at 1-26.

<sup>285</sup> S. J. Liebowitz, and Stephen E. Margolis, "Market processes and the selection of standards" (1996) 9 *Harvard Journal of Law and Technology*. 283 at 316.

<sup>286</sup> P. A. David, "Clio and the economics of QWERTY" (1985) 75 *American Economic Review*. 332 [David]

<sup>287</sup> Thus termed because the first six letters in the upper left-hand corner in the layout are Q-W-E-R-T-Y.

<sup>288</sup> One such model was the Dvorak layout which claimed a 40% increase in typing speed. S. J. Liebowitz, and Stephen E. Margolis, "Market processes and the selection of standards" (1996) 9 *Harvard Journal of Law and Technology*. 283 at 313.

<sup>289</sup> S. J. Liebowitz, and Stephen E. Margolis, "Market processes and the selection of standards" (1996) 9 *Harvard Journal of Law and Technology*. 283 at 313.

<sup>290</sup> David, *supra* note 286.

keyboards, one could find many other real-world examples of network effect in the marketplace.<sup>291</sup>

## 7.2 Synchronization Value and Language

Network effect, however, manifests in a more pronounced fashion with certain types of products more than others. This has to do with the nature of the product. The more it depends upon direct interaction with other products within a network, or a synchronization with a larger support system, the more predisposed it will be to a network effect.<sup>292</sup> A certain “synchronization value,” as Liebowitz and Margolis calls it,<sup>293</sup> is the essence of network effects.<sup>294</sup> Thus, the value of a telephone is more directly affected by an increase in users than say a Ferrari. Of course, as more people buy Ferraris, the price of parts and service might decrease and thus spur more people in turn to buy Ferraris, and so on and so forth.<sup>295</sup> However, a telephone is more attuned to the effects of network externalities precisely because its value is largely derived from its

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<sup>291</sup> Another interesting example of network effect is the competitive pressure Apple computers were feeling from the growth of PCs and PC related computer software and service in the 1990s. This arose from synchronization issues (addressed below). As the operating systems of apple computers were not compatible with PC software, this induced a network effect for the larger PC market. Many speculated on whether or not Apple computer would survive. (S. J. Liebowitz, and Stephen E. Margolis “Network Externalities (Effects)” Management School, University of Texas at Dallas. at 1). Interestingly, after Apple made their operating systems compatible with PCs, this network effect was undercut.

<sup>292</sup> In contrasting the idea of network effect with pecuniary externalities (the effect one person has on another), Liebowitz, and Margolis distinguish between network externalities that involve direct interaction among network participants and those that involve mediation through the marketplace in the form of decreased costs etc. S. J. Liebowitz, and Stephen E. Margolis, “Market processes and the selection of standards” (1996) 9 Harvard Journal of Law and Technology. 283 at 287.

<sup>293</sup> S. J. Liebowitz, and Stephen E. Margolis “Network Externalities (Effects)” Management School, University of Texas at Dallas. at 1

<sup>294</sup> *Ibid.*

<sup>295</sup> Katz and Shapiro’s definition of a network in fact embraces many goods beyond just physically networked items such as telecommunications. They refer to this principle generally as “positive consumption externalities.” They point out that “Positive consumption externalities arise for a durable good when the quality and availability of post purchase service for the good depend on the experience and size of the service network, which may in turn vary with the number of units of the good that have been sold. In the automobile market, for example, foreign manufacturers’ sales initially were retarded by consumers’ awareness of the less experienced and thinner service networks that existed for new or less popular brands.” Katz and Shapiro, “Network externalities, competition, and compatibility”, supra note 280.

place within a larger network. I can always go cruising in my Ferrari if my neighbour has one or not, but what am I to do with my telephone if I have no one to call? The more people who own telephones means I have more people to call. The difference between a telephone and a Ferrari is synchronization value.

The classic example of this is language. As the purpose of language is to facilitate interaction between individuals. A synchronization value lies at its heart. The linguistic dominance of the English language in international business (and the world) over the last thirty years, no doubt can be attributed in large part to a network effect. As more people speak English, the inherent synchronization value of the language increases, in turn drawing even more people into the mind-numbing classrooms of ESL teachers.<sup>296</sup> As the sole purpose of language is to facilitate interaction within a larger network of people, the effects of network externalities on systems of language are palpable. Like my lonesome telephone, what good is fluency in a language if I am the only one who speaks it? Conversely, the value of speaking English grows as the number of people who also speak English, and with whom one therefore can communicate, increases; that is, as its inherent synchronization value increases. This is clear in language. Indeed, now that the world has tacitly nominated the English language as our lingua franca, it is becoming progressively more unlikely that the entire globe will collectively jump to a new language, regardless of possible geopolitical shifts in world power or what have you. As the English language grows in popularity, so too does its implicit value, encouraging further growth—a network effect.

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<sup>296</sup> The author, having taught ESL for over ten years, can attest to the tediousness of such classes.

Now let us return to the focus of our discussion. All of this applies in equal measure to commercial law. Commercial law is an instrument of the market that evolves as it does because it facilitates market exchange. Like language its purpose is to facilitate interaction within a larger network. It is no coincidence that Fuller suggests that customary law might best be conceptualized as a “language of interaction.”<sup>297</sup> It is a language of interaction because it is an instrument of communication between people, synchronizing their interactions.

### **7.3 How Network Externalities Apply: Why Commercial Law is More Like a Telephone than a Ferrari**

Like a telephone, commercial law is a tool to assist specific interactions between different parties. And like a telephone or fax machine, its value is in its ability to facilitate these direct interactions. When we consider the degree to which commercial law arises in response to the demands of the market similar to how any product does, that is, a tool that serves a useful function in that it facilitates direct interactions, the notion that, like certain products, it displays network externalities, is not altogether surprising. Indeed, the number of “consumers” who recognize the same legal norms is analogous to the numbers of consumers who use a product. Thus the adoption of legal norms can be compared to the adoption of VHS format over Beta, or a consumer bringing home a PC instead of a Macintosh.

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<sup>297</sup> Fuller writes, “. . . I shall argue that the phenomenon called customary law can best be described as a *language of interaction*. 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 numbers 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.” Lon L. Fuller, *The Principles of Social Order: Selected essays of Lon L. Fuller*. Edited by Kenneth I. Winston (Durham: Duke University Press, 1981) at 213.

If we think of commercial law as a product, it is one whose value is wholly predicated upon its ability to facilitate interaction between parties within the larger network within which they operate. It thus benefits greatly from synchronization. Commercial law, because it regulates an array of interactions with changing partners within a larger commercial network, is more like our telephone than our Ferrari. It has an intrinsically higher synchronization value, and thus is particularly inclined to a network effect. As with language, the value of commercial law increases commensurate with the number of people who embrace it. And as with language, commercial law benefits enormously from standardization.

#### **7.4 Standardization and Natural Monopolies**

Like fax machines, telephones, and language, the value of a system of law as a standard increases as the number of people who use it grows. Like a telephone with no one to call, or a language that no one speaks, there is not much good in subscribing to a system of commercial law if it is only you who does so. Recall how this synchronization contributed to the spread of the medieval Law Merchant.<sup>298</sup> Having to navigate a diverse assortment of local customs and law, medieval merchants were eager to utilize a uniform system of regulation to oversee their transactions so as to avoid the commercial inefficiency and confusion of dealing with different laws.<sup>299</sup> In this way, standardization offered a clear benefit, as it facilitated their exchanges. Indeed, the fundamental purpose of standardization is to facilitate interaction among individuals by synchronizing their interactions.<sup>300</sup> With telephones, it is having mutually compatible telephones; with VHS

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<sup>298</sup> See above chp 3.5.1: The Law Merchant as a Creation of the Market

<sup>299</sup> *Ibid.*

<sup>300</sup> S. J. Liebowitz, and Stephen E. Margolis, "Market processes and the selection of standards" (1996) 9 Harvard Journal of Law and Technology. 283 at 292.

videocassettes, it is video stores renting VHS tapes that can be played on your VHS player.

Standardization produces synchronization. Synchronization is “the benefit received by users of a standard when they interact with other individuals using the same standard.”<sup>301</sup>

Liebowitz and Margolis point out that synchronization effects will generally increase with the number of people using the same standard.<sup>302</sup> Many have concluded that legal standardization must be created through the auspices of the state. Examining standardization in the law, Landes and Posner argue that this must be imposed by a central authority. They note that

...there would appear to be tremendous economies of standardization in [law], akin to those that have given us standard dimensions for electrical sockets and railroad gauges. While many industries have achieved standardization without monopoly, it is unclear how the requisite standardization of commonalty could be achieved in the [law] without a single source for [law]—without, that is to say, a monopoly.<sup>303</sup>

Benson (like Hayek) concludes that no monopoly is necessary, and that standardization may evolve through a decentralized process.<sup>304</sup> The idea of Network effect is useful here.

Applied to products in the marketplace, network externalities have been used to account for the emergence of “natural monopolies” that generate a precise standard. These “natural monopolies” can arise from the value of synchronization rather than production

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<sup>301</sup> *Ibid.*

<sup>302</sup> *Ibid.*

<sup>303</sup> Landes, William M. and Richard A. Posner, "Adjudication as a Private Good" (1979) *Journal of Legal Studies*. 235 at 239.

<sup>304</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 648. See also generally Hayek, *Law, Legislation, and Liberty*, *supra* note 7.

costs (although production costs should also be affected as well).<sup>305</sup> Applied then to law, network effect offers itself as a more comprehensive explanation of how this process may occur in commercial law. The reply to Landes and Posner's conclusion that in order for standardization to occur there must be a monopoly—is that network externalities can create “natural monopolies.” As with any other product in the market, a natural monopoly may evolve, inducing an uncoordinated standardization.

Thus, where government is absent, network externalities may step in to create standardization. This, however, demands that the product (or activity) is one that has synchronization value, that is to say, that it directly benefits from an increase in the number of people who use it. Commercial law, in that it facilitates interaction between individuals, has a synchronization value, and thus is particularly open to the effects of network externalities.

### **7.5 The More People the Better: Switching Costs**

It is a simple point: the more people who employ a certain system of commercial law, the greater is its value. This is so because, like a language facilitates interaction, commercial law's function is to facilitate commercial interaction. As business men engage in commercial ventures with different parties, a common language is not only useful, the lack of it may mean enormous financial loss. Thus, the more this language is “spoken” the more useful it becomes. This is due in large part to switching costs.

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<sup>305</sup> S. J. Liebowitz, and Stephen E. Margolis, “Market processes and the selection of standards” (1996) 9 Harvard Journal of Law and Technology. 283 at 301.

Switching costs lie at the heart of network externalities.<sup>306</sup> Users may have opportunities to employ alternative products, however, due to the transaction costs involved in switching, it is more efficient (for them) to carry on using the product. With the above example of the QWERTY keyboard, this would be primarily the inconvenience of having to learn to type on a new keyboard and finding such keyboards. With the example of VHS, this would mean running around one's city in a desperate (and futile) attempt to find a beta videocassette for your Beta player. Potential switching costs, in this way, constrain the actions of individuals, corralling them into certain patterns of usage.

Commercial law is no exception to this. Through their use of a certain system of law, merchants become increasingly familiar with these laws. Further, the nature of certain regulations may, at times, even dictate and inform the business strategies they adopt. They learn to use these laws as one would learn to use a language, and, like learning a language, it entails a certain investment. Indeed, if one had to learn a new language with each person with whom one interacted, this would be time consuming to say the least, not to mention somewhat confusing and inefficient. It is more practical to simply use one language, ideally the one that most people speak. Similarly, it is, broadly speaking, far more "efficient" to simply utilize whatever law is used by the majority of individuals with whom one may potentially engage in commercial interactions (assuming of course that the law itself is not terribly inefficient). It is comparatively easier and safer to simply continue employing the form of law that one has used in the past. In doing so, one may avoid unnecessary switching costs. This process may take the form of a utilization of business usages, rules of arbitration, or even choice of jurisdiction. As these trade

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<sup>306</sup> S. J. Liebowitz, and Stephen E. Margolis, S. E. "Policy and Path Dependence: From QWERTY to Windows 95" (1996) 3 *Regulation: The Cato Review of Business and Government*. 33 at 1.

practices “crystallize into commercial usages, business patterns emerge.”<sup>307</sup> These norms proliferate due to network externalities.

Thus, we see a distinct reluctance on the part of many business people to conduct commercial transactions under a law with which they are not familiar. As Wolf points out: “...the prudent tradesman does not enter into a commercial venture if there is a possibility of the transaction being subject to the strange laws and precepts of a country not in the mainstream of international commerce. When faced with the fact of an unfamiliar system of law being applied to any transaction, there arises a law-shy reaction.”<sup>308</sup> This “law-shyness” is due in large part to prospective switching costs.

Moreover, if one learns to utilize a new body of law which few people actually use, this would only underscore the wasted expenditure in terms of switching costs one has paid. One’s “return” on the investment (familiarizing oneself with the law, possibly even modifying ways of conducting business) would be that much smaller if one did not have many future occasions to maximize this investment. Thus, there are distinct switching costs that work to reinforce network externalities on any given body of commercial law.

## **7.6 The More People the Better: the Impression of Legitimacy**

There is another factor that contributes to commercial law’s value increasing in relation to its number of “consumers.” A body of law that is widely recognized, deeply entrenched, and pervasively utilized, provides a certain reassurance that, in the case of dispute, the law will be effectively enforced. A system of law’s overall sense of

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<sup>307</sup> Leon E. Trakman, *The Law Merchant: The Evolution of Commercial Law* (New York: Fred B Rothman & Co, 1983) at 99.

<sup>308</sup> Wolf, *supra* note 2 at 10.

legitimacy strengthens as its number of “consumers” increases. In this way, commercial law is subject to network externalities. Switching costs and a recognition of a system of law’s legitimacy, produce a network effect. As the number of “consumers” goes up, the value of that set of legal norms increases.

### **7.7 How High Engagement Precipitates a Network Effect**

Returning for a moment to Fuller’s description of customary law as a language of interaction: the metaphor is a good one because law is, like language, indeed a tool to regulate human interaction. The intrinsic value of a law is contingent upon its relationship to a larger network.<sup>309</sup> That is, that there is a community of more than one that subscribes to the law. For, like language, what good is a system of law if you are the only person who adheres to it? Its value is thus derived from its ability to coordinate a network of individuals, and as such, like language, it may exhibit network externalities.

Broadly speaking, one could argue this is true of all forms of law. However, this is especially true for commercial law. Why? The answer can be traced back to the element of high engagement commercial law displays. If we can strain the metaphor of language even further: commercial law is a language that is more actively spoken than its non-commercial counterpart. Thus, the element of high engagement renders commercial law particularly susceptible to the effects of network externalities. It does so in several ways.

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<sup>309</sup> Liebowitz and Margolis rightly point out that the fundamental purpose of a standard is that it facilitates interaction among individuals. S. J. Liebowitz, and Stephen E. Margolis, “Market processes and the selection of standards” (1996) 9 *Harvard Journal of Law and Technology*. 283 at 292.

### **7.7.1 Commerce Enlarges one's Circle of Potential Partners**

We should clarify what was just said: the value of a law for an individual actor is derived from it being recognized by a larger group of individuals. However, this largely depends on whether or not the individual actor has points of interaction with the other members in the group. For instance, I am quite content that the criminal code of Canada extends only to roughly thirty million some odd people. Whether this number is thirty or three hundred would only be of consequence to me if there were a chance I might interact with one or more of the extra 270,000,000.

Because commercial activity entails a relatively fluid shifting and broadening of highly focussed expressions of interaction, the value of commercial law as an instrument to facilitate these interactions increases as the number of parties who recognize and employ the law grows—a network effect. This is because those engaged in commerce have a uniquely broad pool of potential partners with whom they may embark on commercial ventures. The nature of trade in fact is oriented towards enlarging this consortium of potential partners. Thus, it is advantageous that more and more individuals employ the form of law to which one is accustomed. And, equally, for an individual selecting legal norms, there is, from the outset, an immediate benefit in learning to conduct one's interactions under the system of law that is most widely used, thus increasing one's pool of potential collaborators that employ similar law.

Compare this with say criminal law, where relationships are relatively static. An individual gains no comparative advantage if more parties subscribe to the law if the individual simply has no occasions to interact with these additional people. It does not

really have any impact one way or the other. After all, what good are other people speaking the language I speak if I never have any occasion to speak with them? By contrast, commercial law offers the potential for engaged interactions with parties well outside ones immediate field of interaction—the opportunity to “speak” with them. Indeed, commercial interaction often involves speaking with people in very distant places, frequently taking a transnational expression.

By creating an enterprise that in effect draws from a vast pool of potential partners, commerce creates a situation where the more people who speak one’s legal language the better. The key point here is that commerce creates a state of affairs in which actors essentially participate in a much wider community of potential partners—in fact, the bigger the better. Commercial partnership is a bridge between disparate parties that in effect widens the scope of ones prospective interactions well beyond ones immediate circle of would-be partners. And as it does so, it cries out for the use of a common language of legal norms. To strain our language metaphor perhaps to the point of utter collapse: while non-commercial law, being more static in its sphere of potential co-actors, can be compared to the language you speak with your immediate family, commercial law might be a language you might speak with your entire street, your city, country, perhaps even a village in central China—and as such, you better pick a language that is widely spoken.

### 7.7.2 Parties Selecting Law with Each New Interaction are Consumers Purchasing a Product

There is yet another important point that contributes to commercial law being especially receptive to network externalities. This is tied up with the fact that, in many respects, contract allows parties to choose the law they wish to use. For the most part, this is not the case with other forms of law. As we have discussed, commercial exchange in and of itself represents discrete cycles of interaction, with each interaction providing an opportunity for the participants to select, and to some extent, even construct specific rules to govern their exchange.<sup>310</sup> This characteristic anticipates a network effect by allowing the “consumers” of legal norms to essentially select elements of the law, or indeed entire jurisdictions of law, comparable to a consumer purchasing a product. Indeed, the predominance of English contract law as a standard for transnational commercial ventures attests to the reality of this effect.

This is nowhere more evident than in the consent to jurisdiction and forum selection clauses of transnational commercial agreements, where, indeed, entire systems of law may be selected over others.<sup>311</sup> This phenomenon of “forum shopping” has in recent decades only accelerated in pace with the advance of economic globalization.<sup>312</sup> Indeed, in “a world where daily transactions routinely involve multiple countries, litigants are increasingly likely to find themselves embroiled in simultaneous contests in several theatres.”<sup>313</sup> The term “forum shopping” has been defined as a litigant's attempt "to have

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<sup>310</sup> Benson, “The Spontaneous Evolution of Commercial Law”, *supra* note 5 at 658.

<sup>311</sup> For a great discussion of choice of law issues in transnational litigation See generally, Andrew S. Bell, *Forum Shopping and Venue in Transnational Litigation* (Oxford University Press, 2003).

<sup>312</sup> *Ibid* at 3.

<sup>313</sup> LE, Teitz, “Taking Multiple Bites of the Apple: A Proposal to Resolve Conflicts of Jurisdiction and Multiple Proceedings.” (1992) 26 *The international Lawyer*. 21 at 22.

his action tried in a particular court or jurisdiction where he feels he will receive the most favorable judgment or verdict."<sup>314</sup> However, the principle of forum shopping may be said in spirit to apply in equal measure to situations where both parties of a commercial agreement select a legal venue as the proper law of their contract for their mutual benefit. In choosing between two prospective jurisdictions, parties will often employ forum selection clauses and/or choice of law clauses to select the system of law that offers a comparative advantage. This then opens the door to a network effect for reasons already mentioned. Like consumers choosing one product over another, consumers of law frequently face a similar choice.

This is equally true for their choice of dispute arbitration procedures along with all the various other elements of their contracts. To be sure, a “min-legislature” convenes session each time a new commercial partnership is formed, invariably promoting the use of certain legal norms over others. The ability for parties to decide on law with each new interaction, allows for a network effect to take place, as there are countless windows through which participants can express their preference for specific rules over others. A general shift towards a particular body of law may thus emerge, experiencing an increasing return as more merchants, influenced by the effects of network externalities, gravitate towards it. In this manner, a sort of natural legal monopoly may emerge, its predominance as a legal standard becoming ever more deeply entrenched over time.

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<sup>314</sup> As cited in “Forum Shopping Reconsidered” (1990) 103 Harvard Law Review.1677 at 1677. Black's Law Dictionary 5th ed., s.v. “Forum shopping”.

An entire system of law as an institution can succumb to a network effect. Indeed, North concludes that institutions do witness the effects of network externalities.<sup>315</sup> Institutional path dependence arises, North explains, as a result of “network externalities, economies of scope, and complementarities that exist with a given institutional matrix.”<sup>316</sup> Further, individuals that derive some comparative advantage from the institutional framework “have a crucial stake in perpetuating the system.”<sup>317</sup> Thus, a system of commercial law can be conceptualized as a path dependent institution, exceedingly sensitive to network externalities.

This is simply not the case with other forms of law, precisely because its structure precludes the possibility of incremental feedback. While commercial law is, in this sense, more fluid and dynamic, other forms of law cannot shift as seamlessly, and in such direct response to the inclinations of its “consumers.” Thus, this stymies the emergence of a network effect on such systems. While the common law, in its reliance on judge made law, does allow for a greater responsiveness when contrasted with statute-based systems of law, this is nowhere near as finely tuned and sensitive as the law that emerges as the direct product of contracting parties. The net effect of this sensitivity is that network externalities can influence the growth of commercial law in a far more manifest fashion, while its non-commercial brother is far more resistant to the self-propagating influences of a network effect.

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<sup>315</sup> Douglass C. North, 1993. "The New Institutional Economics and Development," Economic History 9309002, EconWPA.1 at 3; see also North, Douglass C, "Institutions" (1991) 5 Journal of Economic Perspectives, American Economic Association. 97 at 109.

<sup>316</sup> Douglass C. North, 1993. "The New Institutional Economics and Development," Economic History 9309002, EconWPA. 1 at 3.

<sup>317</sup> *Ibid.*

## **Conclusion**

A great deal of scholarship has looked at the decentralized emergence of law, specifically at the Law Merchant, both old and new. Hayek and Benson, in particular, building on pre-existing spontaneous law theory, postulate as to the ability of law to develop in the absence of a central coercive authority. Law that relates to commercial interaction is especially suited to evolve in this fashion. While law of a non-commercial nature generally requires the backing of a state through which to derive its efficacy, a great deal of commercial law as it exists today has evolved, and indeed continues to evolve in the vacuum of a central authority.

It is clear that markets can and do evolve in precisely such a spontaneous, decentralized manner. Over zealous attempts by some authority or another to redirect the growth of markets through feats of intrusive centralized planning, have in fact frequently been met with dismal failure. Markets evolve as they do, guided by an invisible hand, as an aggregate of countless individuals separately pursuing their own interests. Similarly, the same forces that channel this economic evolution may also induce the growth of legal norms. In this sense, commercial law is unique in that, when left to its own devices, it often arises in response to the needs of the very economic actors it regulates. In many respects, commercial law is an instrument of the market.

Understood in this light, the unique nature of commercial law comes into clearer focus. It emerges from a highly specialized dynamic of human relations, with its own set of governing principles. Commercial law stands apart from other forms of law in that it is uniquely equipped to generate norms in situations where a single legislative power is

notably not present, as it is largely impacted by the choices and behaviour of individual economic actors. The nature of commercial interaction between these agents is profoundly different from other forms of human interaction regulated by non-commercial law. Parties indeed interact in an entirely different way. That is, the manner of interaction involves a higher degree of overall engagement. While the significance of this element of engagement has gone largely unrecognized in theories of spontaneous law, its impact upon the ability of commercial law to evolve in a decentralized manner is enormous. The manner of interaction in commercial dealings, working in tandem with the principle of reciprocal gain, which underlies commercial associations, simply makes systems of commercial regulation more able to follow paths of decentralized evolution.

The idea that commercial actors demonstrate a higher degree of overall engagement in the interactions they pursue has two, intertwined aspects to it: repetition and the creation of discrete cycles of interaction. While the repetition of commercial interactions induces the emergence of norms, the second aspect of high engagement in fact facilitates this tendency by producing clear cycles of interaction that then lends itself to repetition. Thus, these two aspects of engagement are intimately connected. The nature of commerce creates small “chunks” of interaction, and at the same time, encourages parties to run through them again and again. This plays a decisive role in the spontaneous evolution of legal norms. As we saw in the latter half of the discussion, this element of high engagement allows norms to evolve through an evolutionary process reminiscent of natural selection. Further, the engaged nature of commercial interaction also demonstrates path dependant characteristics. Repetition opens the door to a network effect. Without the ability for commercial actors to run through repeated cycles of

interaction, it would be difficult for norms to emerge without relying on some legislative authority.

Commercial law is thus uniquely positioned to evolve in a decentralized, spontaneous manner, more so than any other form of law. As has been widely recognized, this is due to the reciprocal nature of commercial relationships. However, the engaged nature of commercial relationships and the ability of commercial actors to influence the law plays an equally important role in this process. Commercial law is unique in that it possesses both of these elements: reciprocity and a high level of engagement. The twin elements of high engagement and reciprocity serve as the two wings of spontaneous systems of law—if both are present, decentralized legal development may indeed take flight.

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