

## Law and Order Without Coercion

G. Marcus Cole<sup>1</sup>

Stanford Law School

Much of the contemporary discussion regarding law and public policy focuses on *how* government ought to address important issues. From global warming to technological innovation to corporate finance, voters and policy-makers alike share the belief that the tools of government ought to be brought to bear on all of the important matters of our times.

Virtually no attention is given public policy debates, however, to the question of *whether* government ought to address these important issues. In fact, the larger and more complex the issue, the more policy-makers and opinion leaders assume that government provides the only mechanism for addressing such concerns. Two types of “market failure,” in particular, commonly serve as justifications for governmental intervention into and regulation of otherwise private markets and matters. Private market mechanisms are said to fail where society seeks the provision of what are commonly called “public goods,” and also where the cooperation of large groups of individuals are necessary in order to accomplish some task. These latter problems, frequently termed “collective action” problems, can coincide with the problem of

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public goods provision, but can also arise independently of them.

These two typical justifications for imposition of regulation, the “Public Goods” justification and the “Collective Action” justification, have largely been embraced by neoclassical economists, and have been completely unchallenged by legal academics. Nevertheless, the question as to whether and to what extent private actors can regulate their own behavior without government coercion is an increasingly important one.

This Article attempts to answer this question by surveying the literature on private ordering and self-regulating human systems. As such, it demonstrates the many circumstances under which human beings have provided law and order to govern their affairs without the monopolized use of coercive physical force or violence characteristic of, and indeed defining, governmental regulation.

This Article proceeds in three parts. Part I outlines the commonly relied-upon justifications for the use of coercive governmental force to regulate human affairs. These include the “public goods” justification, as well as the “common pool” justification. The conditions surrounding public goods and common pools are assumed to require governmental intervention and regulation, and typical examples of these are explored here. Part I concludes with an explication of the responses to the public goods and common pool justifications offered by Austrian school and classical economists, which provide logical albeit theoretical market alternatives to regulatory solutions.

Part II bridges theory with reality, by exploring the many and varied historical examples of private order solutions to what neoclassical economists refer to as public goods or common pool problems. In this part, the literature expositing these examples is surveyed, detailing the rise, operation, and decline of sophisticated and complex private legal orders of the past. These orders are significant examples, in part because their functioning was often only interrupted by state action and resort to the government’s monopolistic use of legitimized physical force.

Part III brings theory and practice into the present, with an

examination of just a few of the many private legal orders that make modern life possible or prosperous. Unlike many of the historical examples, these modern private legal orders frequently operate “in the shadow of the law” provided by governmental entities. Nevertheless, this survey of contemporary private legal orders illustrates the ways in which many institutions and industries regulate their own members’ behavior and affairs, without resort to the coercive use of physical force entailed by governmental regulation.

Part IV explores the future of private ordering, by surveying the literature proposing innovative market-based solutions to problems commonly thought to be the province of governmental regulators. This part suggests that the future of private ordering is limited only by our imagination and willingness to think freely about the costs and benefits of market alternatives to the use of physical force by state actors.

Part V concludes.

## **I. Providing (Laying Down the) Law**

### **A. Law through Government Coercion**

As a little known philosopher and engineer once said, “I’ve never seen a problem that couldn’t be solved with a little physical violence.” To the advocates of state action, this expression is undoubtedly true. After all, law, as provided by the state, is, in the end, “violence” (Barnett, 1985 and 1999). Some have defined it as the legitimized use of physical violence or force (Barnett, 1985). Government can be seen as having a monopoly on the legitimized use of physical, coercive force or violence.

To be sure, there are many definitions of law. John Austin, for example, defined law as “the command of the commander to the commanded,” and backed by a sanction (Austin, 1885; Posner, 1998). Lon Fuller, on the other hand, defined law as the practice of “subjecting human conduct to the governance of rules” for the purpose of achieving order (Fuller, 1964). But whether one embraces a conception

of law as Kelsen's *grundnorm*, or H.L.A. Hart's "rules of recognition," the fact is that most Western, developed societies are "positivist," reflecting Austin's conception of "command" and "sanction" (Kelsen, 1934; Hart, 1961).

When governmental regulators provide the sanction, that sanction is coercive force—physical violence. While governments do not have a monopoly on the use of physical violence, they do enjoy an exclusive combination of authority and violence. In other words, governmentally provided law, command and sanction, is the exclusive resort to the *legitimized* use of physical violence for the purpose of ordering human behavior.

Physical violence, legitimate or not, is very effective at ordering human behavior. Guns in the hands of Nazi troops were very effective at forcing mothers, fathers, and little children onto the railroad cars headed for concentration camps. But precisely because physical violence is so effective at ordering human behavior, many today, academics and voters alike, assume that physical violence, in the form of governmental regulation or state imposed law, is necessary to solve society's most intractable and recurrent problems of coordination. If it seems like government can do a lot, it is because violence can do a lot.

To be sure, government and its use of coercive force is one approach to solving certain problems. It may be, in some circumstances, the most efficient approach to certain problems, as economist Joseph Stiglitz has argued (Stiglitz, 1989). But just because government can do a lot through violence, it does not necessarily follow that all solutions to problems of order or coordination ought to employ government and violence. It may very well be the case that many, and perhaps the most efficient solutions to problems of social order and coordination are overlooked because of our reliance on government-based coercive force.

To explore whether the coercive violence underlying governmental regulation is over-utilized, we first need to examine the common justifications for its use.

## **B. The “Public Goods” Justification for Government Coercion**

One of the most commonly asserted and widely accepted defenses of government intervention into private activity is the “public goods” justification. A “public good” may be defined as “a good that can be produced only by collective action, but its production benefits people regardless of whether they join in the collective effort” (Schmidt, 1991). Neo-classical economists define a public good as a benefit that is both non-exclusive and not exhausted by consumption (Samuelson, 1964). By non-exclusivity they mean that the good, once provided, benefits both those who pay for its provision as well as those who do not. This “free rider” problem, then, is thought to cause public goods to be under-provided. As a result, government is justified, as this argument goes, to intervene and tax or otherwise coerce beneficiaries of the public good to pay for it. Mancur Olson goes further, asserting that “[a] state is first of all an organization that provides public goods for its citizens, its members” (Olson, 1965). Olson not only justifies state action through the lens of public goods; he justifies the existence of the state itself through public goods.

The public goods argument is also frequently extended to include things which, by definition, are not public goods, but which have some characteristics of public goods. Things that confer positive externalities are things that are, by definition, underappreciated by the market, and therefore worthy of state intervention. Subsidies and patents, for example, owe much of their existence to this extension of the public goods justification (Lemley, 2005; Nachbar, 2005).

The corollary of this extension of the public goods justification is that anything that creates a negative externality warrants governmental regulation or prohibition (Stiglitz, 1989). Monopolies, trusts, and other “anti-competitive” activity, it is argued, undermines competition, raising prices (even where short-term predatory pricing lowers them), and harming us all in the long run. Monopolies, therefore, as the corollary runs, must be regulated, limited, or broken up.

The public goods argument then, as summarized by Michael

Taylor, is that “[t]he most persuasive justification of the state is founded on the argument that, without it, people would not successfully cooperate in realizing their common interests and in particular would not provide themselves with certain public goods” (Taylor, 1987). It follows that government coercion is necessary to provide benefits that rational individuals would deny themselves, as a group, because of the individual’s temptation to “free ride” on the efforts of others.

### **C. The “Common Pool” Justification for Government Coercion**

A related, but not coextensive justification for government intervention is that set of problems which have come to be known in the legal and economics literature as “common pool” problems (Smith, 1987). Common pool problems are a form of collective action problems in which many individuals have a claim on or use for a common resource, but uncoordinated individual efforts to consume that resource lay waste to it.

This “tragedy of the commons” is best illustrated through an example (Hardin, 1968). Suppose a common plot of land with a single resource, say, trees, is bordered by the private property of four individuals, Ms. A, Mr. B, Mr. C, and Ms. D. As a conscientious and considerate neighbor, Ms. A wants to go onto the commons to take just enough firewood to last her through the coming winter. She thinks she should do just that, but then a disturbing thought creeps into her polite, thoughtful mind. What would she do next winter if her three neighbors completely decimated the forest on the commons? Indeed, two of her neighbors may be just as conscientious as she, but what if the third is not? “That one, inconsiderate, selfish, or careless neighbor could ruin the resource for the rest of us,” she thinks. Her next thought is the realization that unless she gathers as much firewood as she is able, she has no guarantee that the resource will be available for her use in the future.

As Ms. A thinks through the possibilities, she is blissfully unaware that Mr. B. has also realized that his enjoyment of the common

resource is assured only to the extent that he carries off as much wood as he can gather in the present, whether he needs it now or not. And as each of the neighbors entertains the same disturbing thoughts, a tragedy ensues. The resource is depleted, not through use, need, or present enjoyment, but through fear and self-preservation. The tragedy is a tragedy precisely because it is so unnecessary. Disinterested and omniscient third party observers can see that each of the neighbors are honest, hardworking, and conscientious. Only ignorance and fear stand between the neighbors and their collective self-interests. They are ignorant about the true character of each of their neighbors, and they fear the worst in any one of them.

The tragedy is also a tragedy because there exists a ready solution to it. Note that the tragedy does not occur on Ms. A's land, even if she happens to harbor a resource the others want or need. The neighbors do not lay waste to her resource because it is *her* resource. She owns it, even if she does not herself need it. The neighbors, desirous of her resource, will pay her for it. She, on the other hand, desirous of something else, will accept payment for it. She will also nurture the resource, protecting it from harm or waste, in order to be able to offer it for sale to those in need of it. In other words, the solution to the tragedy of the commons is to place someone in stewardship over it.

To solve the commons tragedy, we could divide the commons up into quarters, and allocate each quadrant to each of our four neighbors. Or we could assign the rights over the common resource to just one of the four neighbors. If we choose Ms. A, she will care for and sell the resource to those in need of it, just as she would any resource on her original plot of land. Either way, we will have placed one person in stewardship over any part of the resource, and by this we will have gained assurance that it will be preserved for the benefit of anyone needing it, and not wasted through ignorance and fear.

Many free-market advocates stop the analysis at this point, and assert that the solution to the commons tragedy is private property. This is a mistake. It is true that private property "places someone in

stewardship over" the resource, but it is not true that private property is the only device that accomplishes this task. Ms. A, Mr. B, Mr. C, and Ms. D could, for example agree to hire a manager for the common resource. They could also agree to "elect" a representative to manage it. Since ignorance and fear are at the root of the commons tragedy, solutions which address these root problems will solve the tragedy. Private property, contract, or government can address the problems of ignorance and fear. Each of these solutions essentially places one party in stewardship over the resource. The key to solving common pool problems is to establish a single authority or decision-maker over the common pool.

It is important to note at this point that common pool problems are not coextensive with public goods problems. Many common pools, such as natural resources, are thought of by neoclassicists as public goods. When the air in the San Joaquin Valley, or the water in the Hetch-Hetchy Valley is at issue, the overlap between public goods and common pools seems complete.

The assets of an insolvent company, however, present a different common pool problem, one that is private, not public. The claimants on the assets of the firm each wants to be paid in full, and for most creditors, the assets of the firm are larger than any one of their claims. Yet, if all of them pursued their rights unfettered, the assets would be ripped apart, and quite possibly rendered of less value than might have been true had the "going-concern" value of the firm been protected and preserved. In short, creditors can behave like Ms. A and her three neighbors, laying waste to the asset pool in order to satisfy their own individual need to be repaid. In short, rational individual decision-making can lead to all of the creditors, as a collective, receiving less than they might have received had they been able (or forced) to cooperate. Nevertheless, note that this common pool problem is not a public goods problem.

Bankruptcy law is a public, governmentally imposed solution to the tragedy of the commons arising from corporate insolvency (Jackson,



1984). But there are private solutions to corporate insolvency too, and while these may exist in the shadow of bankruptcy law, they cannot be characterized as governmentally imposed or reliant upon state action and violence. In fact, these private solutions existed prior to the establishment of bankruptcy law (Cole, 2000 and 2002). These contractual workouts in debt finance, or “wind-ups” in equity finance, are private alternatives to the government-based solution to the common pool problem.

#### **D. The Difference Between Consensual and Coercive Approaches to Problems of Coordination**

The existence of alternative solutions, public and private, to public goods and common pool problems leaves us with a few questions. First, “if both government-based and private, consensual approaches can both solve these problems, then which approach should we choose?” Second, “if both government and market approaches can solve these problems, then does it matter which approach we choose?” Because the answer to the first question is that there are social benefits to private solutions which coercive solutions have difficulty mimicking. This makes the answer to the second question an emphatic “yes.”

Consensual or contractual solutions to coordination problems can actually *create* wealth, rather than merely redistribute it. To see how this is so, consider the following example. Suppose a village contains just two members, Ms. Able and Mr. Brewer. Suppose further that there are essentially two productive endeavors in which Ms. Able and Mr. Brewer can engage, namely, bread-baking and shoe-making.

Bread-baking is a low-skilled activity. Anyone with time on their hands and the raw materials can do it. Shoe-making, on the other hand, is a high-skilled activity. Those with superior education and training can make more shoes, given the same amount of time and materials, than those without advanced training.

Mr. Brewer is a low-skilled worker. When he spends half a day baking bread, he can bake fifteen loaves. If he were to spend a whole

day baking bread, he could bake thirty loaves. He would never do this, however, since he also needs shoes. Mr. Brewer can make eight pairs of shoes in half a day. He could make sixteen pairs in a whole day, but this would leave him “breadless.” So, Mr. Brewer divides his days. He spends half a day baking bread fifteen loaves of bread, and half a day making eight pairs of shoes.

Ms. Able, as her name implies, is a highly-trained, high-skilled worker. When she spends half of her day baking bread, she can bake 15 loaves. When she spends a whole day baking bread, she can bake 30 loaves. In other words, she performs the low-skilled task with equal productivity as Mr. Brewer.

When Ms. Able turns her attention and talents to making shoes, however, she is able to produce twelve pairs of shoes in a half a day. This is substantially more than Mr. Brewer’s eight pairs in half a day. If she could spend a whole day making shoes, she could actually produce twenty-four pairs. She would never consider doing this, however, since this would leave her breadless.

**Table 1**

	<b>Bread</b>	<b>Shoes</b>
Ms. Able	15	12
Mr. Brewer	15	8
<b>Total</b>	<b>30</b>	<b>20</b>

Suddenly, Ms. Able has an idea. "What if I *do* spend a whole day devoted to doing what I do best: making shoes," she thought to herself. "I could make lots of shoes, and then trade them for the bread I need from someone who spends their time making bread." In short, Ms. Able envisions a contractual division of labor, with her specializing in shoemaking, while Mr. Brewer specializes in bread-baking.

When Ms. Able approaches Mr. Brewer with her idea, he is persuaded to give it a try. If he spends his entire day baking bread, he will produce thirty loaves, and can exchange some of them for the shoes he needs. With this new arrangement, Ms. Able now produces no bread and twenty-four pairs of shoes in a day. Mr. Brewer produces no shoes and thirty loaves of bread in a day.

**Table 2**

	<b>Bread</b>	<b>Shoes</b>
Ms. Able	0	24
Mr. Brewer	30	0
<b>Total</b>	<b>30</b>	<b>24</b>

Notice that, prior to their agreement, when Ms. Able and Mr. Brewer were "self-sufficient," they produced a sum total of 30 loaves of bread (fifteen from Able and fifteen from Brewer), and a sum total of twenty pairs of shoes (twelve from Able and eight from Brewer). After their cooperative agreement, the resultant division of labor result in the same total number of loaves of bread (none from Able and thirty from Brewer), but the total number of shoes is now twenty-four (none from Brewer and twenty-four from Able). The "contract" between Able and Brewer has increased their total productivity by four pairs of shoes. Even if Able agrees to give Brewer only nine pairs of shoes in exchange

for fifteen loaves of bread, they are both better off (Able by three pairs of shoes, and Brewer by one pair of shoes) than they were under the state of self-sufficiency.

The above hypothetical, and Tables 1 and 2, provide a simple illustration of David Ricardo's Theory of Comparative Advantage (Ricardo, 1817). The theory holds that, whenever one party holds special talents, capital, or skills, a consensual exchange with another party, even one with no special endowments, results in wealth creation. The theory of comparative advantage is precisely why free trade between nations, regardless of size or level of development, is compelling.

But the theory of comparative advantage suggests more than just free, consensual exchange is beneficial. It suggests that, when confronted with the choice between consensual and coercive solutions to public good and common pool problems, wealth-creating consensual solutions ought to be preferred over governmental regulation and its reliance upon the use of coercive physical force.

This analysis suggests that the widely held belief that government regulation and its legitimized use of physical violence is the presumptive solution to problems of coordination is without foundation. Why, then, is this belief so common? Perhaps the presumption that government is the solution to all problems persists because of a perception that examples of private solutions are so uncommon. If this perception is the cause of the "government first, last and always" approach to coordination problems, the remainder of this article is intended to deflate this perception. While the multitude of examples of private legal ordering can be organized in numerous ways, this Article characterizes them as either historical or contemporary. Part II explores a few of the remarkable historical examples, while Part III examines the ubiquity of private legal orders today.

## **II. Private Ordering in History**

Since governmental solutions to problems of coordination are

not presumptively superior to private solutions to the same problems, why are there so few examples of private legal orders? Actually, the literature on the history of private institutions, trade, and associations is replete with examples of highly sophisticated private solutions to complex problems. The selected examples explored below include the Maghribi Traders of the 11<sup>th</sup> century, the origins of American fraternal societies, miners and cattle ranchers in the American Old West, segregated schools in West Virginia in the early 1900's, free banking in Scotland in the late 18<sup>th</sup> and early 19<sup>th</sup> centuries, and the emergence of financial markets in Amsterdam and London in the 17<sup>th</sup> and 18<sup>th</sup> centuries.

### **A. The Maghribi Traders**

In his article, *Reputations and Coalitions in Medieval Trade*, Avner Greif describes an intricate trading network that persisted throughout the Mediterranean world in the eleventh century (Greif, 1989). Evidence of these complex trading arrangements were discovered among documents found in the geniza of an ancient synagogue in Cairo in the late 1800's. The documents reveal a society of merchants known as the Maghribi Traders.

The Maghribi were a "coalition" of Jewish merchants residing in North African towns and villages. What makes their business practices of interest is that they traded across the Mediterranean, through overseas agents, without the benefit of government enforcement of their contracts. Instead, the Maghribi relied upon a complex network of religious affiliations and rules of membership, allowing for enforcement of contracts through a stringent reputation mechanism. A merchant in North Africa would place a substantial amount of merchandise into the care of an overseas agent, charged with the responsibility of transporting the items across the Mediterranean for sale in Europe. The agent would sell the merchandise in Europe, and return to the merchant in North Africa with the proceeds, whereupon the merchant would confer upon the agent his commission. Agents

could work exclusively for one merchant, but often worked for several merchants throughout their lives.

The geniza documents provide explanations of how the ordinary practice of trans-Mediterranean trade was conducted, in part because it also contained records of “trials” and other dispute resolution proceedings. When disputes arose, they were settled under Jewish law, and often within the local synagogue. When an agent or merchant was found guilty of cheating the other, the sanctions were heavy. They included expulsion from the trading network. In other words, an agent found guilty of “skimming” profits or otherwise cheating his merchant would never be entrusted with goods again, not just by the injured merchant, but by any Maghribi merchant along the Northern coast of Africa. To enforce these judgments, names and descriptions of the offender were posted in synagogues throughout the region.

Punishments for merchants found cheating their agents were equally harsh, and included prohibitions against the use of Maghribi agents for overseas trade, as well as stiff monetary damages. One of the harshest penalties took the form of prohibiting the children of offending merchants and agents from participating in the trading network.

The penalties for breaching overseas trading agreements appear to have been quite effective. In fact, the geniza records include many examples of agents and merchants willingly paid multiples of the claimed damages, purportedly in an attempt to provide assurances of future trustworthiness.

What makes the Maghribi Traders example particularly noteworthy is the fact that a complex regime of contracts were enforced entirely without the aid or “shadow” of government and coercive force. No government of the eleventh century could claim jurisdiction of the entire Mediterranean. Nor is there any evidence that any of the contracts among the Maghribi traders were subject to any government enforcement. This private legal order was enforced entirely through reputation mechanisms. Even the “end game” scenario, which

capitalizes on the weaknesses of many reputation mechanisms, fails to undermine the Maghribi system. The desire to see ones children take over the lucrative family business appears to have caused even “retiring” agents and merchants to respect their contractual commitments.

### **B. American Fraternal Societies**

Private ordering need not always entail commercial transactions or relationships to work. They can also be centered upon social welfare and mutual aid. David Beito, in his article *Mutual Aid for Social Welfare: The Case of American Fraternal Societies*, exposes the important role once played by the now seemingly innocuous fraternal associations that dot the landscape of middle class America today (Beito, 1990).

According to Beito, an estimated thirty percent of the adult male population of the United States belonged to fraternal societies in the years leading up to the Great Depression, and an even larger percentage of African-Americans belonged to such organizations. After churches, these organizations were the largest providers of aid and social welfare in the United States. Unlike the government welfare state that would succeed it in the “New Deal,” these fraternal societies were based upon a concept of reciprocity and mutuality. The largest of these groups included the Masons, the Elks, and the Odd Fellows, but other smaller fraternal societies functioned the same way.

The principal function of these fraternal societies, as originally conceived, was to provide mutual aid. This aid took several forms, including housing and care for elderly members, health and accident insurance, and burial insurance. For example, by 1929, thirty-nine Masonic jurisdictions, and forty-seven Odd Fellows chapters had built homes for their elderly members. Interestingly, even in an era before Social Security, few of these homes needed to be filled to capacity.

Similarly, fraternal societies of the nineteenth and early twentieth centuries provided members and their families death and health insurance benefits. In fact, prior to the Great Depression, fraternal societies dominated the health insurance market for the

working class. This was due in large part to the competitive advantage of fraternal societies in checking "moral hazard." Insureds were much less likely to abuse coverage with the knowledge that others in the brotherhood would bear the burden.

Fraternal societies were particularly important in the African-American community. Excluded from many of the institutions and benefits associated with white organizations, African-American formed their own, extensive network of mutual aid societies. The largest of these were the Prince Hall Masons, with a membership of nearly a third of the adult male population. The Prince Hall Masons provided perhaps more services than their white counterparts, including orphanages and employment bureaus in addition to medical insurance and homes for the aged.

Mutual aid societies began to decline in use in the late 1920's and early 1930's, just at the onset of the Great Depression and the New Deal. While there are several plausible theories for their decline, Beito offers adverse selection and the rise of state insurance regulation as the most likely culprits. Since membership premiums were uniform, bad risks were subsidized, in the long run, by good risks. In such a scenario, it is only a matter of time before the good risks catch on and defect from the insurance pool, leaving just the now unsubsidized bad risks. State prohibitions on certain forms of insurance, such as individual old-age insurance plans, may also have doomed fraternal aid societies. In the end, the onset of the welfare state substituted government aid for private, mutual aid. Consensual, contractual solutions to the problems of common risk pools gave way to the coercive, tax and spend regimes that characterize social insurance today.

### **C. Miners and Cattle Ranchers of the American Old West**

The Old West provides numerous examples of order without government. Many of these examples involve coordination problems. Yet, there are few coordination problems that pose the difficulties of the provision of law itself. Law is often regarded as the quintessential



public good (Morris, 1998). Nevertheless, Andrew Morris, in his article, *Miners, Vigilantes, and Cattlemen: Overcoming Free-Rider Problems in the Private Provision of Law*, has chronicled the development of customary legal orders in mining communities in California and the Black Hills, cattlemen in Montana, and the vigilance committees of San Francisco. Most of these legal orders developed prior to the arrival of governmental authority in those territories.

While these various communities had many differences, they all shared some things in common in their efforts to provide their own private law. First, they all developed their own rules regarding claims, land acquisition, and trespass. These rules were established by contractual agreements among the various community members.

Second, these communities policed or enforced violations of the actual social compact through group action. A consensus that a violator needed to be punished was reached, and once reached, depended upon the community acting *en mass* to bring the violator into compliance or driven out of the society. In fact, enforcement in these communities depended heavily on consensus, since individual enforcement was at least discouraged, and often prohibited individually enforced sanctions.

#### **D. Segregated Schools in West Virginia in the Early 1900's**

Some of the best historical examples of private ordering illustrate how market forces can provide so-called public goods at the very same time that the tools of government and coercion are being used to suppress them. Economist Price Fishback provides just such an example in his article, *Can Competition Among Employers Reduce Governmental Discrimination? Coal Companies and Segregated Schools in West Virginia in the Early 1900's*.

Fishback reports that in the first decade of the twentieth century, West Virginia, like many other Southern states, afforded public education to all white children, but only a handful of black children through the state's segregated school system (Fishback, 1989). At the very same time, coal companies in West Virginia, desperate for labor,

sought ways to attract workers. The companies found black workers relatively unresponsive to increased wages, in part because segregated West Virginia gave black workers few channels to spend the money they earned. The coal companies soon realized that one way to attract workers was to offer them something that money could not buy, namely, quality education for their children.

The coal companies, in response to this market opportunity, opened private schools for the children of black workers. The schools were quickly regarded as high quality, even by white parents in surrounding communities. In fact, the educational quality of these schools was so well regarded that white parents began to seek admission to the schools for their own children. Elementary education, often characterized as a prototypical public good, was produced at a level of quality so high that it led to one of the rare instances of white parents in the segregated South seeking to have their children educated alongside black children.

### **E. Free Banking in Scotland, 1792-1845**

Perhaps the one area in which government activity is nearly universally perceived as essential is in the area of central banking. George Selgin provides good reason to question this presumption in his book on *The Theory of Free Banking: Money Supply Under Competitive Note Issue*. In his book, Selgin tells the story of a sophisticated, highly complex, and indeed modern banking system that operated in Scotland from 1792 until it was abolished by act of Parliament in 1845 (Selgin, 1988).

During the period of free banking in Scotland, the country enjoyed no central bank, and imposed no banking regulations of any significance. Instead, banks were fully exposed to the market, and this exposure in turn prompted conservative banking practices. Because banks were permitted to fail, as some did from time to time, the success or failure of a bank depended entirely on how well it was managed and its reputation for reliability and stability.

The operation of Scottish banks during the period of freedom was straightforward. Each bank issued its own pound notes, redeemable for specie at the bank. The value of these notes depended entirely upon the bank's stability and its reputation for honoring each and every note. Failure to honor a note was tantamount to failure of the bank.

A merchant accepting a Scottish bank pound note would deposit the note in his own bank. The merchant's bank would credit the merchant's account for the value of the note, while forwarding the note through a clearing-house to the originating bank. The originating bank would identify the note as its own, forwarding specie through the clearing-house back to the merchant's bank in redemption of the note.

The market discipline of this system lay in the practical requirement for banks to maintain adequate reserves of specie. Failure to maintain conservative levels of reserves exposed a bank to runs, and, in the end, ruin. This system of free banking operated relatively uneventfully until it was ended when the British Parliament sought to extend the reach and authority of the Bank of England by the passage of Peel's Act in 1845.

## **F. The Emergence of Stock Markets in Amsterdam and London**

Advocates of state rule making often assert that private legal orders can only operate in the shadow of government and coercive rule enforcement. Yet some of the most complex of all orders, public or private, have emerged outside of or prior to the reach of government regulators. Economist Edward Stringham, in two articles, explains the early development of stock markets in Amsterdam and London as characterized by private rules operating without resort to government enforcement.

In the early 1600's, at a time when government courts were not enforcing many financial contracts, the commodities bourse in Amsterdam became the locus of trading in sophisticated financial instruments, including equities, futures, and option contracts

(Stringham, 2003). These trades occurred in a relatively open regulatory environment, even though the Dutch government repeatedly undertook steps to limit or ban many of these practices. Short-selling, in particular, brought government scrutiny, since it was believed at the time to a manipulative way to foster volatility in the market. Despite official prohibitions and ordinances banning speculative transactions, these trades persisted throughout the seventeenth century.

The persistence of sophisticated speculative trading in direct contravention of governmental regulation and law raises an important question. If the transactions at issue were illegal, how could parties to them trust that they would be honored? Stringham demonstrates that the traders on the Dutch bourse relied almost exclusively on reputation mechanisms to enforce their contracts. Disreputable traders were marginalized, and eventually driven out of business. Successful traders guarded their reputations as precious capital in a highly competitive market.

Stringham reports a similar, but more formal reliance on reputation in the spontaneous emergence of the London Stock Exchange (Stringham, 2002). In 1762, one hundred and fifty brokers, in an effort to screen out less reputable trading partners, “contracted with Jonathan’s Coffeeshouse to use it exclusively.” When this attempt at forming a private club failed due to the lawsuit of an excluded broker, the members eventually formed a members-only Subscription Room, limiting membership to those of “the most respectable character,” and imposing fines on those whose transactions or behavior failed to achieve this standard.

While the London Stock Exchange operated as a private club with private law, it faced competitive pressure from other exchanges, including the Royal Exchange and the trading floor made available by the Bank of England, to make and keep its private rules efficient. The effectiveness of the exchange’s private law is highlighted by the fact that in 1877, after more than 100 years in operation, the British Government itself declared that the Stock Exchanges rules “had been salutary to the

interests of the public.” In short, the private law enacted and enforced by the London Stock Exchange had been a public good.

### **III. Private Ordering Today**

It may be easy to dismiss the numerous historical examples of complex legal orders and relationships in the absence of government and coercive force as quaint artifacts of a bygone era. The dismissals become more difficult, however, when the illustrations take on a contemporary context. Characteristics of private legal ordering can be found among diamond merchants in New York’s Diamond District, Underwriters’ Laboratories, cattle ranchers in California’s Shasta County, Peru’s black market for housing and street merchants, the Japanese financial clearinghouse “guillotine,” and the “London approach” to corporate reorganization. Each of these examples is explored below.

#### **A. The Diamond Merchants**

Perhaps the most widely recognized example of extra-legal private ordering today is that brought to light by Lisa Bernstein in her article, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry* (Bernstein, 1992). In it, Bernstein describes a complex world of very simple rules and relationships. Diamond merchants, in order to participate in the diamond business at the wholesale level, must be members of a diamond bourse. Membership in the bourse entitles is highly prized because it entitles members to distribute diamonds from the mining companies on the international market retailers and sub-wholesalers at the national level.

But because membership is both prized and limited, members of the bourse fiercely guard their reputations for fair dealing. Members also agree that should a dispute arise with another member of the bourse, the dispute will be resolved before a committee comprised of members of other bourse members. Under no circumstances is a member of the bourse to take a dispute to a government court of law.

Cheaters who are unwilling to submit disputes to the bourse, or unwilling to abide by decisions of the bourse are subject to banishment, not just from their local bourse, but also from diamond bourses around the world. Photographs and names of cheaters are circulated and posted in each bourse to ensure enforcement of the system and its rules. There is even a remedy against “end game” strategies of those nearing retirement from the diamond business: children of cheaters are banished from the diamond industry too. Unlike many private legal orders, the diamond merchant order exists within the context or backdrop of the potential for government law enforced. Nevertheless, the diamond merchants and the rules of the bourse operate without specific reference to external legal relationships of law enforcement. Like the financial markets of 16<sup>th</sup> century Amsterdam, the diamond bourse can be thought of as a legal order operating in spite of, rather than in the shadow of, government-based law.

### **B. Underwriters Laboratories**

In his article, *A Symbol of Safety: The Origins of Underwriters' Laboratories*, Harry Chase Brearly, the metallurgist who invented stainless steel, depicts a private order arising out of necessity and consent. Insurance companies in the late nineteenth century were confronted with a problem. As Brearly puts it,

No sooner have we seized upon some new facility than we are likely to learn that nature may exact a serious price for its use. One evidence of this is found in fire losses which, in the United States, *increased more than one thousand per cent* between 1865 and 1922, while the population increased but two hundred percent. A study of fire causes shows that a large part of that loss can be traced to comparatively new devices and processes (Brearly, 1997).

In other words, insurers faced a problem of information asymmetries. On the one hand, even if insureds were not engaged in moral hazard, insureds had more information about which products they would purchase and use in the home than insurers could ever

access. On the other hand, insurers had access to the most state of the art scientific testing and expertise. Furthermore, all of the insurance companies shared the same interest in reducing unnecessary fires. The difficult question before the insurance companies was “how do we get sophisticated scientific information into the hands of relatively unsophisticated consumers, in a form in which consumers can make use of the information to reduce fires?”

The answer came when several insurers agreed to pool resources to test and certify household devices. Consumers without any scientific background or education at all could rely upon the simple Underwriters’ Laboratories mark as an assurance that a household device was safe. Manufacturers, in turn, could use UL certification as a marketing tool, channeling their own reputational capital into this simple signaling device. In short, the problem of information asymmetry and coordination between manufacturers, consumers, and insurers, was solved through the pursuit of self-interest to the benefit, or public good, of all.

### **C. Shasta County Cattle Ranchers**

Private ordering does not merely provide solutions to coordination problems in the absence of law. It also can provide more efficient solutions to coordination problems when law attempts to solve them inefficiently. An example of this can be found in the rural, Northern California county of Shasta, as documented by Robert Ellickson in his book, *Order Without Law*.

Ellickson describes the simple and long-standing rule developed by Shasta County cattle ranchers to avoid or quickly settle disputes over encounters with a neighbor’s cattle. California law already provides legal rules and procedures for handling such disputes. The formal state law divides portions of the county into two types of land for purposes of cattle trespass disputes, namely, “open-range” and “closed range” (Ellickson, 1991).

The difference between the two types of range reflects the

different types of environments in which cattle might be found to trespass onto a neighbor's property. In the relatively more densely populated areas, designated as "closed range," cattle are required to be fenced and controlled. Any breach of a neighbor's property is an offense for which the cattle owner is strictly liable. In the relatively less densely populated areas of the county, designated as "open range," cattle must be expected to wander and graze. Accordingly, the formal state law rule provides for no liability, even if the damage to a neighbor's property is the result of the cattle owner's negligence.

The actual rule followed by the people of Shasta County bears virtually no resemblance to California state law. The rule followed by residents is very simple: if cattle trespass on a neighbor's property, the owner of the cattle is liable for any damage caused. Ellickson makes clear that this rule is unenforceable in court. Nevertheless, court cases enforcing the formal rule are virtually non-existent. Ellickson suggests this is because, as the ranchers themselves told him, almost everyone follows the informal rule.

When Ellickson pressed the residents of Shasta County to explain how this informal rule is enforced, they explained that the sanctions for breach were a matter of very tough and assisted "self-help." While the residents gave some examples of accounts of which they heard, few claimed to have been eyewitnesses to, let alone to have participated in, enforcement.

#### **D. The Black Market for Housing and Necessities in Peru**

When formal, state-operated legal orders operate inefficiently, they can lead to more than just the inconveniences of rural life in Northern California. Inefficient government-based legal rules can lead to poverty and despair, as graphically exposed by Hernando de Soto in his book, *The Other Path: The Invisible Revolution in the Third World* (de Soto 1989).

In Peru, after years of failed socialist policies and government corruption, the people, according to de Soto, have taken their economic



condition into their own hands. The unavailability of affordable housing due to unrealistic building codes has forced many prospective homeowners to invest in black market real estate. These homeowners purchase apartments or houses without approval or recognition of the formal land transfer or recording authority or laws. The unofficial title obtained is respected and honored, however, by neighbors and newcomers, as evidenced by the marketability of informal deeds. Neighbors actually assist in repelling squatters to enforce informal titles to land.

A similar black market has arisen for the provision of necessities. Although the government requires vendors to hold licenses in order to sell goods on the street, the process of obtaining a license is cumbersome and fraught with corruption and red tape. Even when a vendor is able to obtain a license, formal, legal distribution channels are characterized by chronic shortages.

Fortunately, the poor in Peru have been able to rely upon black market vendors to provide their basic necessities, including food and clothing, at prices lower than available in licensed, "authorized" vendors. According to de Soto, these informal markets provide an "other" path, more promising than the alternative alluded to in the title's thinly veiled reference to the Marxist Shining Path guerilla movement.

### **E. The Japanese Financial Clearinghouse Guillotine**

Although free banking, on the scale of eighteenth century Scotland, no longer exists, many of the private ordering structures upon which free banking was based can be found within many modern institutions. An example of this is provided in Mark Riser's explication of the Japanese financial clearinghouse system and its "guillotine" (Ryser, 1997).

In *Sanctions Without Law: The Japanese Financial Clearinghouse Guillotine and Its Impact on Default Rates*, Riser the informal but devastating enforcement mechanism underlying Japan's financial

clearinghouse. At the end of each day's business, banks receiving checks or promissory notes drawn on another bank submit them to the clearinghouse for presentment to the originating bank. The clearinghouse, which has already transferred funds for the instrument, is then repaid by the issuing bank. This system breaks down, however, if an issuing bank refuses to pay on one of its checks or notes.

In order to protect the clearinghouse and the system, banks refusing to honor their checks or notes are subjected to the most severe of punishments, namely, they are precluded from processing any further business through the clearinghouse. Furthermore, any other member bank not severing ties with the offending bank is effectively ejected from participation in the clearinghouse. In short, the consequence for a bank that fails to honor its instruments is, quite literally, death. Accordingly, the practice has come to be known as the "guillotine," and it is believed to minimize bank default rates in Japan.

#### **F. The "London Approach" to Corporate Reorganization**

Sanctions in the private legal orders governing corporate finance are not always so abrupt and final. When large British corporations find themselves in financial distress, and in need of restructuring, the resort to an informal process known as "The London Approach" (Armour and Deakin, 2001).

According to John Armour and Simon Deakin in their article *Norms in Private Insolvency: The 'London Approach' to the Resolution of Financial Distress*, large corporate insolvencies in Britain are routinely handled outside of the formal processes associated with bankruptcy. A company seeking to restructure in Britain, given the absence of an equivalent to Chapter 11 in American law, approaches its "lead banker" to negotiate a deal with its other creditors. The lead banker then helps the company develop a restructuring plan, which the lead bank will then present to the other creditors.

The lead banker is typically in a position to do this, since it ordinarily holds a blanket security interest in the assets of the firm.

When the lead bank originally lends to the debtor corporation, it typically syndicates its debt position by selling off a "piece of the action" to other London banks, which routinely purchase it" for purposes of investment diversification. In a symbiotic manner, the lead banker on one corporation is likely to be a participant in another company with syndicated debt. After securing unanimous consent from the other creditors to the restructured debt contracts, the lead bank oversees the corporate restructuring.

When a participating bank refuses to cooperate with the lead bank, two types of informal or semi-formal sanctions are threatened or employed. First, uncooperative banks are shunned from future debt syndications, effectively locking them out of a relatively small club of fewer than 300 banks. Second, the lead banker can request that the Bank of England conduct enquiries into the reasons for the bank's reluctance. This sanction, involving a face-to-face meeting with bank regulators, is referred to as "being asked to tea with the Queen." Since participating banks seek to avoid either sanction, the judgment of the lead bank in the restructuring is often respected. The lead bank's judgment is trusted too, since it is just as likely to be in a reciprocal position when the next large corporate distress case is announced.

#### **IV. The Future of Private Ordering**

The prevalence of historical and contemporary examples of private legal orders is no guarantee that such systems will be relied upon to solve coordination problems in the future. Indeed, the growth of government and the extra territorial assertion of governmental authority in cases involving intellectual property or internet traffic suggests that private legal orders will have significant competition from coercive regulatory regimes.

Cause for hope can be found among the increasing number of scholars and policy makers considering private legal alternatives. Some of the characteristics of successful private orders, however, might temper our hope with cause for concern.

Several scholars have posited private legal orders to supplant many activities that most observers assume are the natural function of government. Legal scholars such as Randy Barnett have envisioned “polycentric legal systems” (Barnett, 1984). These legal systems would abandon government courts, replacing them with private judges modeled on today’s arbitrators and mediators. Barnett would actually encourage the development of private, contractual and non-territorial police forces, with overlapping jurisdiction and pre-negotiated treaties to resolve disputes between forces. Jurisdictional competition between courts and police forces, according to Barnett, would result in increasingly efficient and fair law enforcement.

Another glimmer of hope for the expanded reliance on private ordering arises from the Free Market Environmentalism movement. Economists like Terry Anderson, Donald Leal, and others have demonstrated the effectiveness of market forces at regulating unwanted behavior (Anderson and Leal, 1991). In many instances, these measures have already proven more successful at natural resource conservation than government regulation (Schmidtz and Willott, 2001).

A third source of opportunity for private ordering arises from the growth of cyberspace. While much on-line activity appears to be unregulated, it should be noted that at least one scholar, Lawrence Lessig, has identified numerous ways in which human behavior is constrained and ordered by the architecture, norms, and private institutions comprising the internet (Lessig, 2000). These private legal structures are in a battle with government regulators for control of the space that Lessig characterizes as a commons (Lessig, 2001).

One final area for the increasing resort to private law is in the area of transnational corporate governance. Most markets are now global in scope, and corporate activity is increasingly transnational. National governments have stepped up attempts to regulate and tax transnational corporate activity, even when that activity takes place partially or wholly outside a particular nation’s borders. Corporations have attempted to combat these encroachments through various

corporate governance devices, including “ring-fencing” and choice of law provisions in contracts. Ring fencing is the practice of severing corporate activity into distinct corporate subsidiaries, so as to remove that activity from the reach of certain legal regimes or jurisdictions (Cole, 2002). Both ring-fencing and contractual choice of law provisions are limited in effectiveness, however, as long as they are based upon existing, governmentally-based legal regimes. Choice-of-law provisions, for example, are limited for reasons of efficiency, among others, to a handful of legal regimes (most typically, New York or Delaware law) (Eisenberg and Miller, 2006). Similarly, ring-fencing requires corporate actors to choose an existing corporate law regime for purposes of chartering and application of the internal affairs doctrine for choice of law (Cole, 2002).

Even if opportunities for private ordering appear to be expanding, they should not be approached with ungarded optimism. Many of the historical examples of private legal orders suggest we proceed with caution. Andrew Morriss depiction of Montana cattle ranchers, for example, appears to imply a requisite level of homogeneity of interests and characteristics between members of or participants in the private legal order (Morriss, 1998). If this is true in other cases, private legal orders may be as detrimental to the prospects for freedom as they are to its enemies.

One check on these types of concerns, however, might be the freedom of market actors to choose the orders to which they belong. To be welfare enhancing, private orders must be consensual. Otherwise, they devolve into government. This constraint limits the ability of many types of *ex post* property coordination problems, for example, from being true private orders, rather than the most oppressive form of coercive governmental force (Heller and Hills, 2007).

## **V. Conclusion**

Contemporary public policy debates are replete with discussions of how government should solve problems of social coordination.

Rarely do such discussions begin with a justification for government action and its implicit use of physical violence, nor do such discussions explore whether government is even the appropriate institution for addressing coordination concerns.

This Article attempts to place the “horse before the cart.” First, it demonstrates that knee-jerk assumptions about the appropriateness and effectiveness of government approaches to coordination problems are false at a theoretical level. Second, it surveys the literature on private legal solutions to problems of coordination. This survey shows that historical examples of market-based solutions to coordination problems abound. Furthermore, this Article shows that many contemporary examples of private ordering operate independently of formal, state-based law enforcement.

Finally, this article suggests areas of opportunity for the future of private ordering, but cautions that private ordering is not a universally utopian solution to all problems of human coordination.

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