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## The Role of Lawyers in Removing Economic Activity from State Supervision

W. Mark C. Weidemaier

University of North Carolina School of Law, [weidemaier@unc.edu](mailto:weidemaier@unc.edu)

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# The Role of Lawyers in Removing Economic Activity from State Supervision

W. Mark C. Weidemaier\*

## I. INTRODUCTION

Economic activity does not always depend on state-created law (to set the rules), state-funded courts (to resolve disputes), or state coercion (to enforce compliance). These well-known facts have motivated a large and inter-disciplinary literature spanning law, economics, history, sociology, anthropology, and other disciplines.<sup>1</sup> To take a famous example, Robert Ellickson documented how ranchers in Shasta County in Northern California observed behavioral norms that differed from the law's requirements and enforced these norms not through legal coercion but through gossip and other social mechanisms.<sup>2</sup>

This short essay is prompted by Steven Ware's *Private Ordering and Commercial Arbitration*, which appears elsewhere in this volume.<sup>3</sup> Ware's article is a thoughtful and persuasive reflection on the importance of Soia Mentschikoff to the voluminous literature on private ordering, as well as a call to recognize the importance of arbitration as a tool of self-governance. I largely agree with him on these points. I do, however, want to use Ware's discussion as a point of departure, highlighting an important question that he seems to overlook—as, indeed, does most of the private ordering literature.

For the most part, that literature asks two questions. First, *why* do some communities reject state-created law and legal institutions for “tailored law and a separate system of governance”?<sup>4</sup> Second, *how* do such communities solve the “problem of enforcing agreements in exchange”?<sup>5</sup> In other words, what are the mechanisms by which self-governing communities lend certainty to transactions among members? These questions are important, but they do not make a complete set. A community that aspires to self-governance must do more than facilitate trade. In

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\* Ralph M. Stockton, Jr. Distinguished Professor, University of North Carolina School of Law. Thanks to Melissa Jacoby and Steven Ware for helpful comments on prior drafts.

1. For a recent summary, see BARAK D. RICHMAN, STATELESS COMMERCE: THE DIAMOND NETWORK AND THE PERSISTENCE OF RELATIONAL EXCHANGE (2017).

2. ROBERT C. ELICKSON, ORDER WITHOUT LAW (1991).

3. Stephen J. Ware, *Private Ordering and Commercial Arbitration: Lasting Lessons from Mentschikoff*, J. DISP. RESOL. (forthcoming 2018).

4. Richman, *supra* note 1. Answers tend to focus on the efficiency gains from private adjudication, see Lisa Bernstein, *Opting out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 126 (1992) (noting that one benefit of arbitration is that some disputes “are common enough that they are dealt with consistently according to widely known customs” that differ from ordinary rules of contract law); Ware, *supra* note 3 at 14 (noting that arbitration may help facilitate cross-border transactions by facilitating award enforcement), or the efficiency gains from private enforcement, see Barak D. Richman, *Norms and Law: Putting the Horse Before the Cart*, 62 DUKE L.J. 739, 762-66 (2012) (emphasizing the importance of enforcement efficiencies).

5. See, e.g. Gillian K. Hadfield, *The Many Legal Institutions that Support Contractual Commitments*, HANDBOOK OF NEW INSTITUTIONAL ECON. 175 (Claude Ménard & Mary M. Shirley, eds. 2008).

many cases, it will also have to navigate a constantly-shifting relationship with the state itself. There may be overlap, but the tools required for this task may be very different from the tools that facilitate and enforce transactions. Yet this question—*How do self-governing communities create and maintain independence from state law and institutions?*—has not attracted much attention.

The discussion to follow begins by using Professor Ware's thoughtful article to highlight how easy it is to overlook this important question. My primary contribution, however, is a case study of my own, which I will keep very brief due to space constraints. That case study draws on archival research into the operation of the London Stock Exchange (LSE), arguably the most important institution in the capitalist world during the 19th and much of the 20th centuries.<sup>6</sup> The LSE's relationship with the state was anything but frictionless, and much of the LSE's internal work was devoted to ensuring that state legal actors maintained an appropriate distance. As we will see, this work was often explicitly legal, and lawyers played important roles. Observing their work reveals how the law and legal institutions—including the norms such institutions foster in lawyers—can subtly support and constrain private ordering activities.

## II. FROM MENTSCHIKOFF TO THE PRESENT: GAPS IN THE PRIVATE ORDERING LITERATURE

Judged by metrics like citation count or the esteem of scholars of arbitration and commercial law, Soia Mentschikoff's *Commercial Arbitration* is one of the most influential pieces of scholarship in the arbitration canon.<sup>7</sup> A deeply realist exploration of commercial arbitration practice among trade association members and before the American Arbitration Association, *Commercial Arbitration* is, among many other things, an early model for the empirical study of alternative dispute resolution processes. Mentschikoff rejected broad generalizations, such as the "folklore"<sup>8</sup> view of arbitration as an ad hoc process in which the rules and norms of trial practice simply do not matter.<sup>9</sup> Instead, she emphasized that "the structure and the process of commercial arbitration are determined by the different institutional contexts in which it arises."<sup>10</sup> And she demonstrated the importance of institutional context empirically, revealing important differences between trade association arbitration and commercial arbitration conducted under the auspices of the American Arbitration Association (AAA).

For Ware, Mentschikoff's study of trade association arbitration is noteworthy for raising "fundamental questions about the roles of private parties in the production, application, and enforcement of law."<sup>11</sup> He has long been interested in such

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6. Larry Neal and Lance Davis, *The Evolution of the Structure and Performance of the London Stock Exchange in the First Global Financial Market, 1812-1914*, 10 EUR. REV. OF HIST. 279, 279-80 (2006).

7. Soia Mentschikoff, *Commercial Arbitration*, 61 COLUM. L. REV. 846 (1961).

8. Edward Brunet, *Replacing Folklore Arbitration With a Contract Model of Arbitration*, 74 TUL. L. REV. 39, 42 (1999).

9. Soia Mentschikoff, *The Significance of Commercial Arbitration*, 17 LAW & CONTEMP. PROBS. 698, 706 (1952). For instance, she dismissed as "patent nonsense" the claim that rules of evidence and procedure do not influence arbitration practice.

10. Mentschikoff, *supra* note 7 at 848.

11. Ware, *supra* note 3 at 18.

questions, and in arbitration in particular, emphasizing problematic as well as beneficial consequences of taking dispute resolution private.<sup>12</sup> Like Mentschikoff, Ware is especially interested in trade associations and other self-governing merchant communities. The study of such communities is integral to the broader literature on private ordering, and Ware rightly emphasizes Mentschikoff's importance to this literature. It is worth pointing out that Ware proves one can write about Mentschikoff's work without mentioning that she was once married to another prominent law professor.<sup>13</sup>

I have little to add to Ware's assessment of Mentschikoff's importance and few complaints with his call to recognize the importance of arbitration as a tool of private ordering. I do, however, want to probe an assumption he makes about the state's relationship to trade associations and similar communities. Ware situates such groups along what we might call the "government support" continuum. At one pole, we find examples in which state actors actively support private ordering. For example, in some settings, trading partners may have little reason to fear that breach or other malfeasance will harm their reputation or have other adverse, extralegal consequences. If they submit disputes to arbitration, the winner will need state actors to help enforce the award; states devote significant resources to making this possible.<sup>14</sup> At the opposite pole, we find private ordering against a backdrop of vigorous state opposition. Ware cites the Mafia and other criminal organizations as examples.<sup>15</sup> In his view, trade associations like those studied by Mentschikoff fall into a middle zone of state neutrality, receiving "neither significant government support nor significant government opposition."<sup>16</sup>

This continuum is analytically useful, for it reminds us of Mentschikoff's admonition that context matters.<sup>17</sup> If private ordering requires varying amounts of state support and encounters varying amounts of state opposition, then the process of arbitration should reflect these relationships. For example, we might expect stricter confidentiality requirements to accompany arbitration when conducted against a backdrop of state opposition. But I am not sure I accept Ware's assumption that trade associations occupy a position of neutrality with regard to the state. More fundamentally, I would caution against assuming that such groups enjoy a static, relatively frictionless relationship to the state, such that private ordering activities take place against a stable backdrop of government support or opposition. This may occasionally be true, but it will often be false. For instance, state actors may become intensely interested in regulating transactions they previously viewed with indifference.

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12. For example, he has emphasized that, because of limited judicial review, arbitration has the potential to convert civil rights and other ostensibly mandatory laws into default rules. See Stephen J. Ware, *Default Rules from Mandatory Rules: Privatizing Law Through Arbitration*, 83 MINN. L. REV. 703 (1999).

13. A search for Soia /s Mentschikoff in Westlaw's Law Reviews and Journals database produces 384 hits. Of these, nearly one-third (123) refer to the other law professor by name within the same paragraph. Only a few of these references seem necessary—for instance, to accurately describe aspects of the Uniform Commercial Code's drafting history. By contrast, when an article refers to the other professor, Mentschikoff's name appears within the same paragraph only two percent of the time.

14. Ware, *supra* note 3 at 7-8.

15. Ware, *supra* note 3 at 6-7.

16. *Id.* at 7.

17. Mentschikoff, *supra* note 7 at 848.

By keeping in mind that the attitudes of state actors often shift over time, we can see a host of questions that, as I have noted, the private ordering literature mostly overlooks. These are not the usual questions about how private actors use private institutions to create and enforce their preferred rules of exchange. Instead, they are questions about how communities that aspire to self-governance keep the state at bay.<sup>18</sup> This latter set of questions is important, for the answers reveal that the law and lawyers can support and constrain extralegal institutions in subtle but important ways.

### III. THE LSE AND THE ROLE OF LAWYERS IN CREATING SPACE FOR SELF-GOVERNANCE

Let me give two examples drawn from materials in the LSE archives at the London Metropolitan Archives and Guildhall Library.<sup>19</sup> Though never fully independent of the state, the LSE was largely self-regulating,<sup>20</sup> and its rules allowed transactions, such as time bargains and options, that courts would not reliably enforce.<sup>21</sup> To protect such transactions, and to ensure the consistent application of its rules, the LSE resolved many disputes internally (via committee vote), and it also required members to arbitrate disputes arising out of exchange transactions. In addition to these rules governing dispute resolution, other LSE rules limited the risk that state actors would scrutinize exchange practices. For example, exchange members originally could not be incorporated bodies and could form partnerships only with other members.<sup>22</sup> The LSE took violations of these rules seriously, frequently by suspending or expelling members.<sup>23</sup>

18. Even the literature on criminal organizations, which cannot overlook the fact of state opposition, tends to overlook such questions. In their study of the Japanese organized crime, for instance, Milhaupt and West focus on how organized crime fills in for an inefficient, state-sponsored system of rights enforcement. Curtis J. Milhaupt & Mark D. West, *The Dark Side of Private Ordering: An Institutional and Empirical Analysis of Organized Crime*, 67 U. CHI. L. REV. 41 (2000).

19. Most materials are found at reference code CLC/B/004. References beginning with MS14600 are to CfGP meeting minutes, followed by the volume or file number, the page number (where available), and the date. References beginning with MS14612 are to the minutes of the Sub-committee on Rules and Regulations.

20. Brian R. Cheffins, *Does Law Matter? The Separation of Ownership and Control in the United Kingdom*, 30 J. LEGAL STUD. 459, 482 (2001).

21. E. VICTOR MORGAN & W.A. THOMAS, *THE STOCK EXCHANGE: ITS HISTORY AND FUNCTIONS* 63 (2d ed. 1969). As one 19th century treatise on the LSE put it: “These remarks as to the voidability of [options] contracts ... do not, of course, apply to bargains made between members of the Stock Exchange, for they are bound by their rules ... to refer their disputes to a tribunal which does not afford to persons dissatisfied with their contracts such facilities for repudiating them.” RUDOLPH E. MELSHEIMER & WALTER LAURENCE, *THE LAW AND CUSTOMS OF THE LONDON STOCK EXCHANGE* 25 (1879). Note the whiff of disdain with which the authors—a prominent lawyer and member of the LSE—refer to the public courts. See also William A. Birdthistle & M. Todd Henderson, *Becoming a Fifth Branch*, 99 CORNELL L. REV. 1, 13-15 (2013) (discussing the similar early history of the New York Stock Exchange).

22. RANALD C. MICHIE, *THE LONDON STOCK EXCHANGE: A HISTORY* 97-98 (1999). These rules limited the capital available to members but also reduced the likelihood of disputes involving non-members, who could not easily be prevented from bringing disputes to the courts.

23. It may be analytically helpful to distinguish private ordering regimes that rely on private enforcement from those that rely on courts and other public actors. See Richman, *supra* note 4 at 762-66. But the distinction can be artificial, as entities need not fall neatly into one camp or the other. The LSE viewed public enforcement as a risk to its autonomy and preferred to keep members in line through private enforcement mechanisms. But it also closely monitored legal developments and worked to make sure that courts would honor its rules and customs in the event private enforcement failed.

The LSE's place on what I have called the government support continuum was anything but fixed. To the contrary, public attitudes towards the exchange and its members shifted widely over time, as one might expect of an institution associated with recurring financial crises: "Whenever stock prices endured a period of sustained decline, Parliament would again consider legislation designed to limit the perceived excesses of stockjobbers."<sup>24</sup> Because of these constant state intrusions, much of the LSE's internal work involved questions about how to best maintain independence. Lawyers played a key role in this work.

In one illustrative episode, the Committee for General Purposes (CfGP), which was responsible for the LSE's overall management, learned of a lawsuit against an exchange member named Dunbar, brought by a non-member ostensibly employed as Dunbar's clerk.<sup>25</sup> Dunbar had promised the clerk "a salary at a rate equal to half the net profits of the business,"<sup>26</sup> and the CfGP quite reasonably viewed this arrangement as a forbidden partnership with a non-member. Hauled before the Committee, Dunbar defended himself, in part, by claiming to have acted on a solicitor's advice that the arrangement did not constitute a partnership.<sup>27</sup> However plausible the defense, Dunbar escaped serious penalty, as a resolution declaring that he had "incurred the severe censure of the Committee" failed by a 10:10 vote.<sup>28</sup>

Apparently concerned by this precedent—and by the risk that disputes arising out of profit-sharing agreements with non-members would invite public scrutiny—the CfGP asked the Sub-Committee on Rules and Regulations to look into revising LSE rules to forbid similar arrangements. The Sub-Committee's meeting minutes reflect that this process involved extensive consultation with lawyers, who ultimately recommended amending the rules both to explicitly forbid profit sharing arrangements and to give the LSE itself final authority over what constituted a forbidden arrangement. Thus, the solicitors advised adding language to the rules to clarify that the CfGP's decisions about "what constitutes Partnership within the meaning and intention of the Rules shall be final."<sup>29</sup> This change to LSE rules effectively closed a loophole that had given courts an opportunity to review the business dealings of LSE members and to opine on the range of business relationships that could comply with exchange rules.

In another episode, a member filed a lawsuit against his late partner to resolve a dispute concerning partnership liabilities. The lawsuit violated the spirit if not the letter of the LSE's rules, which required members to arbitrate disputes and forbade them to "attempt to enforce by law against another member a claim arising out of a Stock Exchange transaction." Although a sub-committee had recommended suspending the member for violating this rule, the CfGP was concerned that courts might review and reverse such a decision. The problem was that the dispute arguably did not arise out of a "Stock Exchange transaction." At the CfGP's request, the LSE's solicitors reviewed the sub-committee's recommendation and recommended against suspension, opining that "there is nothing in the Rules to compel the parties

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24. STUART BANNER, *ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS, 1690-1860* 88 (1998). Jobbers were simply dealers who traded for their own account, although the term had long been used pejoratively. *See, e.g.,* MORGAN & THOMAS, *supra* note 21 at 21-23.

25. MS14600/92/29 (Mar. 3, 1913).

26. MS 14600/92/101 (Mar. 31, 1913).

27. MS 14600/92/101-102 (Mar. 31, 1913).

28. *Id.*

29. MS 14600/92/195-196 (May 19, 1913); MS14600/92/222 (June 9, 1913).

to submit their partnership differences to the decision of the Committee.”<sup>30</sup> Once again, the episode prompted amendments to the rules to ensure that future partnership disputes were subject to the arbitration requirement. And again, lawyers played a central role.<sup>31</sup>

The LSE archives are replete with such episodes, in which lawyers play key roles in creating space for self-governance. In performing these roles, lawyers rely on fundamentally legal techniques: reasoning by analogy to cases, modeling procedural recommendations on public court procedures, opining on whether non-members could be forced to arbitrate grievances against members,<sup>32</sup> advising how to ensure that judges deferred to exchange practices etc. Observing their integral role in maximizing the LSE’s independence from the state, it becomes clear that state legal institutions—and the norms they foster in lawyers—can subtly support and constrain private ordering activities.

#### IV. CONCLUSION

For lawyers and legal scholars, self-governing communities may seem to represent a fundamental “rejection of their trade.”<sup>33</sup> Perhaps this explains why the legal literature, in particular, is most concerned with why some members of society opt out of state-sponsored law and institutions and how these members structure private institutions to facilitate trust and cooperation. These are important questions, but we should not let them obscure the fact that self-governing communities rarely enjoy frictionless relationships with the state. To the contrary, they must create and maintain space for self-governance, deploying legal and non-legal tools to keep state actors at an appropriate distance. The LSE illustrates the important role that law and lawyers can play in this process.

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30. MS14612/3/86-88 (Jan. 27, 1916).

31. MS14612/3/86-103.

32. MS14612/1 (July 4, 1871).

33. Richman, *supra* note 1.