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THE CHOICE BETWEEN PUBLIC AND PRIVATE LAW: THE DIAMOND INDUSTRY'S PREFERENCE FOR EXTRA-LEGAL CONTRACTS AND A PRIVATE LAW SYSTEM OF DISPUTE RESOLUTION

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The Choice between Public and Private Law: The Diamond Industry's Preference for Extra-legal Contracts and a Private Law System of Dispute Resolution*

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Abstract

The diamond industry employs its own private system of law rather than the law of the state. Written contracts are not used; transactions are consummated with a handshake and repetition of the phrase "mazel u'broche." This article explores why this market with its sophisticated transactors has largely rejected public law in favor of a system of private law with its own rules, sanctions and institutions for dispute resolution.

The article identifies the characteristics of public law that make legally enforceable contracts unattractive to diamond dealers and concludes that if commercial transactions in the diamond industry were governed solely by legally enforceable contracts under which the promisee could recover expectation damages in the event of breach, the market would be characterized by frequent inefficient breach of contract due to the uncertainty of recovery, the inability of the courts to accurately calculate damages, the length of time it takes to obtain a judgment and to the fact that many diamantaires do not have ready access to capital markets.

After identifying the defects in the public law regime, the article considers the reasons that the diamond industry is able to create, and more importantly enforce, its own system of private law. The central focus is on the way that the organization of the industry facilitates the use of reputation bonds, and how the industry's private dispute resolution institution uses these bonds to enforce its judgments. The aggregate efficiency of the system is assessed and the substantive and procedural reasons that arbitration is preferred to litigation are discussed.

The paper concludes that the diamond industry provides strong support for the hypothesis that in order for extra-legal norms to trump legal rules in a given market, market participants must first conclude that adhering to such norms, would, over time, be in their own best interest-- that is, such norms must be perceived as being Pareto Superior to the established legal regime.

Introduction

The diamond industry employs its own private system of law rather than the law of the state. This article explores why this market with its sophisticated transactors has largely rejected public law in favor of a system of private law with its own rules, sanctions and institutions for dispute resolution.

Part I provides a brief overview of the diamond industry. It sketches the workings of the international diamond cartel and discusses diamond production and valuation. Part II describes the organization of the market for rough and polished diamonds, paying special attention to the role of trading clubs (bourses). It focuses on the terms and structure of transactions and details the workings of the bourse's private arbitration system in which all judgments are kept secret as long as they are promptly paid.

Part IIIa briefly considers why diamond dealers need to make executory contracts and explains that the diamond market is also an implicit loan market. Part IIIb compares the cost of entering into legally unenforceable ("extra-legal") agreements to the cost of entering into legally enforceable contracts. It concludes that the transaction costs of entering into legally enforceable agreements cannot explain diamantaires preference for extra- legal agreements and suggests that the norm of "secrecy" which pervades the industry is at least a partial explanation for diamond dealers' preference for privately enforced agreements.

Part IIIc considers the characteristics of public law that make contracts enforced through litigation an unattractive option. The section's primary focus is on the way courts calculate expectation damages. It argues that if commercial transactions in the diamond industry were governed solely by legally enforceable contracts under which the promisee could recover expectation damages in the event of breach, the market would be characterized by frequent inefficient breach of contract. It attributes this inefficiency to the uncertainty of recovery, the inability of the courts to accurately calculate damages, the length of time it takes to obtain a judgment and to the fact that many diamantaires do not have ready access to capital markets.

Although many of the shortcomings in the American legal system that make litigation unattractive to diamond dealers are also present in most commercial contexts, what is unique about the diamond industry is its ability to create and, more importantly, to <u>enforce</u> its own system of private law. Part IIId focuses on how the organization of the industry facilitates the use of reputation bonds, and how the bourse's arbitration system uses these bonds to enforce its judgments. Two paradigms of reputation bond based extra-legal contractual regimes are discussed: the homogeneous group regime which is generally associated with repeat transactions among members of small geographically concentrated and ethnically homogeneous groups, and the information intermediary paradigm in which technology is used to link markets and to achieve the rapid and low cost dissemination of information about reputation. The section concludes that while the industry is currently moving from a homogeneous group to an information intermediary based regime, it has succeeded, at least for the time being, in creating a system that captures the advantages of both types of regimes.

Part IIIe explores some of the efficiency implications of the use of reputation bonds and compares the incentives they create to the incentives provided by expectation damages. Part IIIf discusses the substantive and procedural reasons why arbitration is preferred to litigation. Parts IIIg-h assess the aggregate efficiency of the system and the importance of reputation bonds in the market as a whole.

Part IV uses a model of arbitration and settlement to explain why most disputes are resolved co-operatively without recourse to a third party arbiter. The section concludes that while the damage rules adopted by the industry may lead to some instances of inefficient breach, the system's over all success in facilitating the low cost rapid conclusion of transactions and in reducing the deadweight loss of dispute resolution might make this private system of law Pareto preferred to a market based on legally enforceable contracts and frequent recourse to the courts.

Part V considers the factors that have lead to the gradual introduction of legally enforceable written contracts in certain types of diamond transactions. It also discusses the increasing influence of civil law on the terms of transactions and the resolution of disputes.

Part VI concludes that the diamond industry provides strong support for the hypothesis that in order for extra-legal norms to trump legal rules in a given market, market participants must first conclude that adhering to such norms, would, over time, be in their own best interest-- that is, such norms must be perceived as being Pareto superior to the established legal regime.[1]

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[1]This point has been overlooked in much of the literature on legally unenforceable cooperation which, for the most part, is characterized by a

Part I: An Overview of Diamond Production and Valuation

The market for rough and polished gem quality diamonds is best understood in the context of the chain of production and distribution that begins in a pit mine and ends up in a retail jeweler's window. Rough diamonds are found primarily in Africa, Australia, and the Soviet Union; they are not notably rare. At present, 80-85% of the world's supply of rough diamonds is controlled by the DeBeers Cartel. The Cartel distributes its supply of rough diamonds through four brokers who sell pre-sorted boxes of diamonds to some 150-200 dealers, known as sightholders,[2] during ten viewing sessions, or sights[3], held in London each year. Most U.S. sightholders are members of the New York Diamond Dealers Club.

The Cartel insists that the diamonds be paid for in full within seven days of the sight. Consequently, for most sightholders, particularly those who cut and polish the rough

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rigid division between authors who argue that extra-legal norms exist in the shadow of the law and are directly influenced, if not determined by it, and others who argue that such norms grow up wholly outside the law. This paper concludes that the admixture of legally enforceable agreements and extra-legal norms that shape the behavior of market transactors in the diamond industry provides support for the idea that the various case studies can be reconciled by recognizing that the relative efficiency of legal rules as compared to intra-industry norms, would be expected to influence, if not determine, the extent to which one or the other will dominate commercial transactions.

A similar thesis is advanced by Robert C. Ellickson in "A Hypothesis of Wealth Maximizing Norms: Evidence from the Whaling Industry," 5 J. Law, Economics, & Organization, 83 (1989) where he explores the "hypothesis that when people are situated in a close knit group, they will tend to develop for the ordinary run of problems norms that are wealth maximizing." at 84.

[2] There are several kinds of sightholders: large manufactures who cut and polish the stones themselves, mid size rough dealers who resell the contents of their boxes to select small manufacturers who trade among themselves and finally cut and polish the stones, and brokers who deal in industrial diamonds.

[3] At a sight a dealer is given a box of diamonds and informed of its price. This price is non-negotiable. If the dealer decides not to purchase his box, he will not be invited to subsequent sights. Consequently, a sightholder will rarely decline to purchase his box, and will instead negotiate in advance to sell it to another dealer on a cost plus profit basis.

themselves, access to credit is essential-- it takes three to four months from the "sight" date for a manufacturer to sort, cut, polish, and sell the contents of his box. Sightholders, however, rarely have difficulty securing financing. In the diamond industry, having a sight is viewed as a near guarantee of financial success. The Cartel actively monitors the business decisions and activities of sightholders and if a sightholder continues to play by the Cartel's "rules," he is rewarded with a more profitable selection of stones. Consequently, because most monitoring costs are shifted to the Cartel, sightholders generally have access to bank capital.

Diamond valuation is a subjective process. The value of a rough diamond depends on the value of the polished stones that can be manufactured from it. Because no two diamantaires will cut a stone the same way, the value added in the manufacturing process varies widely. Consequently, when dealers value a piece of rough differently, the difference in the amount they are willing to pay for the stone often reflects a real difference in the value of the polished stones they will cut from it.[4]

In contrast, when dealers value a polished stone differently, most of the difference will be due to their differing estimates of market demand. Some of the difference will also be due to their differential skill in detecting flaws

4 A dealer's ability to operate at a profit depends on his ability to accurately estimate the value of the polished stones he can cut from a piece of rough. Thus, it is reasonable to assume that there is at least a loose correlation between the price a dealer is willing to pay and the value of the product he will produce. However, the value a dealer attaches to a piece of rough will also be affected by his estimate of the demand for polished stones of particular sizes and qualities.

in stones. In recent years, however, the "skill" factor has become less important. Although older dealers maintain that even polished diamonds cannot be objectively graded and valued, in the late 1970's, the Gemological Institute of America began to issue diamond grading certificates. The widespread use of these certificates made it possible for dealers with little gem expertise to enter the market, resulting in increased competition. In addition, by creating standardized ways of describing goods, grading certificates have facilitated the flow of price information. A private diamantaire now publishes a weekly price list with a wide international circulation and operates an electronic billboard of goods for sale worldwide that can be accessed by a personal computer.[5]

As a consequence of the standardization of grading and the availability of price lists, the market for polished diamonds has become more competitive, and prices have dropped.[6] This has reduced the profit margin of manufacturers who find themselves squeezed between the price of rough fixed by the Cartel, and the competitive prices in the polished market.[7]

Part II. The Market for Rough and Polished Diamonds

a. The Trading Club as a Commodities and Information Exchange

The largest and most important trading Club (bourse) in the United States is the New York Diamond Dealers Club ("DDC").[8]

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5 The billboard lists 12 to 15 million dollars of merchandise each week. See Rapaport Diamond Corporation: Introduction to the Diamond Trading System (15 W. 47th Street, New York, N.Y. 10036)

6 Price lists give retailers an idea of what wholesalers are paying for their stones. The availability of this information has decreased the markup between wholesale and retail.

7 The mark up from mine to consumer is estimated to be between 200 and 400 percent.

8 Another bourse, the Diamond Trade and Precious Stone Association, is located on the same block as the DDC. Its By-laws are similar to the DDC's

Club membership gives a dealer prestige and an important economic advantage. In the diamond industry, access to a steady supply of goods is essential to the operation of a profitable brokerage or manufacturing business. Although it is possible to buy stones on the "open market," a dealer who does not have access to the trading Clubs-- essential links in the world wide diamond distribution network-- will be at a competitive disadvantage. Approximately 80% of the rough diamonds coming into the United States pass through the hands of a DDC member, as do 15-20 % of the polished stones. In addition, 20-50% of the transactions conducted by or on behalf of foreign dealers are concluded in the Club.[9]

The New York Diamond Dealers Club currently has 2,000 members; there is a waiting list for admission. Although requirements for membership are strict, the main constraint on membership is space, not the inability of dealers to meet the membership requirements.[10] As a condition of membership, a

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and it too has an arbitration board to resolve disputes among its members and is a member of the WFDB. Since 1986, the DTA has gradually become an exchange primarily for colored stones.

[9]Despite the strict limits on the number of members it accepts, the DDC tries to attract out of town dealers (and non-members) to its trading hall. Before being admitted to the trading hall, out-of-town dealers must be introduced by a member in good standing who agrees to assume "full financial responsibility (guarantee) for the out of town dealer's acts and liabilities, incurred while on the premises of the DDC."DDC By-Laws: Article XVII: Sec. 2a. Consequently, non-members who want access to supply find it advantageous to maintain a reputation for scrupulous honesty with Club members. The out-of-town dealer must also be approved by the Board of Directors, pay a fee determined by the Board, and agree to adhere to all of the Club's By-Laws, including the obligation to arbitrate all disputes. In return for his sponsorship, a member who introduces an out-of- town dealer is entitled to collect a commission of 1% on every transaction the out of town dealer consummates.

[10]To be considered for membership a dealer must: (1) have been in the industry for a least two years; (2) comply with all requests for information put to him by the Board of Directors; and (3) have his picture posted in the Club for 10 days so that members have the opportunity to state reasons that he should not be accepted. New members are put on probation for a period of two years during which "the Board of Directors reserves the right to

dealer must sign an agreement to submit all disputes arising from the diamond business between himself and another member to the Club's arbitration system.[11] The agreement to arbitrate is binding. Unless the Club opts not to hear the case, the member may not seek redress of his grievances in court. If he does so he will be fined and/ or expelled from the Club. Furthermore, since the agreement to arbitrate is binding, the court will not hear the case.

Most large and important dealers are members of the Club, but they do not usually conduct their business in the Club's trading hall. In the diamond industry, where profitability depends largely on a dealer's "network" of contacts, secrecy is valued; large scale transactions tend to be consummated in private offices. In addition, because properly valuing a stone depends on the ability to detect minor flaws and color variations, buyers prefer to examine large stones in familiar

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terminate such membership at any time within this period for any reason." DDC By-Laws: Article III, Sec. 8. New members are charged a $5,000 initiation fee and annual dues are $2,000.

Although corporations may designate individuals to become members of the Club and to trade on their behalf, these individuals do not enjoy limited liability as they would under the civil law. The arbitration By-Laws provide that "Every member is personally responsible for all transactions with other members, whether he conducts business individually, as a member of a partnership or through a corporation." DDC Arbitration By-Laws: Article XII, Sec. 25. In addition, the corporation or partnership is considered liable and it too is bound by the members agreement to submit all disputes to the DDC arbitration system. DDC By-Laws: Article III, Sec. 2b.
The traditional view of diamond trading as a family business is reflected in the membership By-Laws: more lienent rules govern the admission of sons, daughters, sons-in-law and daughters-in-law. See DDC By-Laws: Article III, Sec. 2a. Widows of members are automatically accepted and do not have to pay an initiation fee. Similarly, the "wife of an incapacitated member may be accorded entry into the Club at the sole discretion of the Board of Directors *until her husband becomes active.*" DDC By-Laws: Article III, Sec. 3b.

[11] The By-Laws provide that "A member's signature on his application for membership and his agreement to abide by and be subject to the By-Laws of the Diamond Dealers Club, Inc., shall constitute a written agreement by him to submit to or defend any controversy thereafter arising out of or related to the diamond business by or against another member or group of members, to arbitration in the arbitration tribunals of the Diamond Dealers Club." DDC By-Laws, Article XII, Sec. 1d.

light. Furthermore, for security reasons, many dealers do not want it to be known that they have valuable stones in their possession. Larger dealers will, however, come to the Club's trading hall to get a feel for market prices. As one dealer explained, a visit to the Club enables him to "keep a finger on the pulse of the business." Although a price list[12] is available for certain classes of polished stones, the trading floor of the bourse is the only place to obtain a feel for the market price of rough diamonds; standardized price information is unavailable. Unlike other commodities exchanges the DDC itself does not record either actual transactions prices or the volume of transactions.[13]

Smaller dealers, brokers, and foreigners do most of their trading in the Club. For them, Club membership provides a secure trading place at a modest cost and has additional informational benefits. In general, the reputations of smaller dealers are less well known. Club membership enables them to signal to others that they are trustworthy, and, conversely, gives them the assurance that all the dealers in the trading hall have fulfilled the requirements for Club membership, an important non-transaction specific piece of information.

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[12] This price list is published weekly by a private Diamaintaire Martin Rapaport. Unlike a closing quotation on a typical commodities exchange, the prices recorded in Rapaport's Diamond Price Report are not actual transaction prices. Rather, they are the Rapaport Corporation's subjective calculation of the "high asking" price for various sizes and grades of polished stones. The "high asking" price is estimated to be between 15 and 30% above the actual transaction price.

[13] Although the DDC does record the number of stones that have been weighed on its scales, this may or may not be a reflection of the number of transactions. Dealers often trust each other to accurately represent a stone's weight, and many negotiations that begin at the Club are concluded in private offices most of which are equipped with scales. The Federal Trade Commission estimates that 700-800 dealers use the Club each day.

The bourse is an information exchange as much as it is a commodities exchange. As one author put it, "the bourse grapevine is the best in the world. It has been going for years and moves with the efficiency of a satellite communications network. . . Bourses are the fountainhead of this information and from them it is passed out along the tentacles that stretch around the world."[14] The bourse facilitates the transmission of information about dealers' reputations,[15] and, at least with respect to members, serves both a reputation signaling and a reputation monitoring function.[16]

The New York DDC is a member of the World Federation of Diamond Bourses ("WFDB"), an umbrella organization composed of the world's twenty diamond bourses. An individual dealer who is a member of one bourse in the World Federation is automatically allowed to trade at any member bourse. All member bourses have similar trade rules, and like the individual bourses, the WFDB has an arbitration system to resolve differences between its members. As a condition of membership in the World Federation, each bourse is required to enforce the arbitration judgements of

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[14] V. Berquem, "Bourses More than a Place to Sell," Jewellery News Asia August (1988)

[15] For example, the DDC's bulletin boards carry letters from dealers who feel they have been victimized by baseless gossip. These letters contain rebuttals and frequently include strong language condemning the integrity of dealers who spread baseless rumors. Sometimes, in addition to being posted, such letters are distributed in the trading hall or on 47th Street itself.

[16] The purposes of the Club as stated in its By-Laws, are, among other things, "to inculcate just and equitable principles in trade, to eliminate abuses and unfair trade practices relative thereto or affecting the same, to diffuse accurate and reliable information concerning the matters relating thereto, [and] to produce uniformity in the conduct of business ethics." DDC Arbitration By-Laws: Article II

other member bourses to the extent permitted by the law of the country in which it operates.[17]

b. The Standard Transactional Paradigm

Although diamantaires insist that a handshake accompanied by the words "mazel u'broche" creates a binding agreement, the question of whether diamond contracts are "oral" or "written" is actually quite complex. There are several steps in a typical diamond transaction where terms, facts and conditions are sometimes written down.[18]

If 100 honest diamond dealers were in attendance and a buyer and seller said "mazel and broche" and shook hands on a deal, even if nothing was written down in the process, it would be clear that a binding contract had been formed. If either party failed to live up to his promise, his reputation would be damaged. Section One of the Trade Rules provides: "Any oral offer is binding among dealers, when agreement is expressed by the accepted words "Mazel and Broche" or any other words expressing the words of accord."[19] Thus, a writing is <u>not</u> necessary for the consummation of a binding agreement, and many deals are consummated in the purely oral manner just described.[20]

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[17] For more information on the rules of the World Federation <u>See</u> <u>World Federation of Diamond Bourses: Bye-Laws and Inner Rules</u> (Mimeo: Antwerp, Nov. 15, 1988)

[18] Older dealers continue to transact on the basis of purely oral agreements and steadfastly refuse to change their way of doing business. Younger dealers, however, appear to be more worried about breach of agreements, and tend to use some written instruments when consummating transactions.

[19] DDC By-Laws: Article XVIII, Sec. 1

[20] Although the By-Laws of the DDC state that the Arbitration Board will only enforce offers given in accordance with open cachet, a formalistic way of concluding a deal that is described in the text infra at 12, as a matter of custom, the arbitrators routinely accept such cases. In practice, a purely oral agreement is generally enforceable in arbitration if there is

The most common transactional paradigm is known as "open cachet."[21] When a buyer makes an offer to a seller or a broker, the stone is put in an envelope which is then folded and sealed in a precise way. The terms and conditions of the offer are placed on the envelope as is the date. The buyer then signs the parcel across the seal. Unless otherwise specified, this offer is considered binding upon the offerer until one o'clock the next day.[22] The seller may accept at any time during this period simply by saying *"mazel and broche"*. However, if the seller either rejects the offer or makes a counter offer during

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some corroborating evidence, such as the testimony of a third party witness, that it took place.

[21] Another type of cachet used less frequently than open cachet is known as "Zee'ch." In a Zee'ch transaction, the seller seals the stone and signs the parcel. This signals his agreement not to show the stone to anybody else for a period of 24 hours. A Zee'ch seal does not give the buyer an option to purchase the sealed stone at a particular price. Rather, it gives him an exclusive right to resume negotiations for the stone at a specified time in the future. It is common for buyers to shop around by putting a variety of stones under "Zee'ch," which in Yiddish literally means "search." This practice makes sense in the market for rough stones where no standardized price information is available; it makes comparison shopping easier which facilitates competitive pricing.

[22]There are additional business reasons for the use of written terms on a cachet parcel. If the buyer who made the offer and created the binding option contact cannot be reached by a seller who wants to accept the offer within the proscribed period of time, the seller, assuming that he is a member of the Club, is entitled to "place his acceptance of the offer, in writing, on the same wrapper and have the time of his acceptance certified by a member of the Board of Directors of the Diamond Dealers Club." Without this formality and its attendant trade rule, a buyer who regretted making an offer could simply refuse to see visitors or take phone calls until the cachet period had elapsed. Reachability is a factor that would be difficult and costly to monitor. So many excuses could be given that a dealer's reputation might not be damaged at all by this type of breach, thus a more explicit form of contract is used since the type of effective bond (reputation) that is necessary for an extra-legal contract cannot be devised. This may be why a more explicit contract is used--clearly this is more efficient than requiring a person to be reachable for the full twenty four hour period surrounding an offer.

Although the "cachet" is an agreement between a buyer and a seller, its most important function in the market is to regulate the relationship between a seller and his broker. If no cachet were used and the Buyer offered 500 dollars per karat for the stone, the broker might tell the seller that the buyer offered 400 dollars. If the seller accepted, the broker would retain the difference. This is not the type of dishonest behavior that could be easily monitored and enforced through reputation bonds since detection and a determination of the precise circumstances would be difficult.

this period, his option to accept the buyer's original offer is cancelled. [23]

When a deal is physically concluded on the floor of the DDC, a document that comes closer to what a lawyer would view as an integrated writing is frequently, but not always, produced. After the parties have made an oral agreement and gone through the formality of cachet -- that is, at a stage in the transaction at which the parties already consider themselves bound-- they take the goods to be weighed by a Club employee who issues them an official weight slip.[24] The slip is then signed by the person who gave the stone to the Club official, most commonly, though not exclusively, the buyer, and the terms of payment and the price are added.[25] Only one copy

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[23]Although in the most common open cachet transactions a buyer makes an offer to a seller, sometimes a seller will offer a stone to a buyer at a particular price and give him a specified period of time to consider the offer. When this is done the seller will sometimes put the stone in a cachet, note the price, and the time on the wrapper, sign the wrapper, and let the buyer take possession of the stone during the option period. (Sometimes the transfer is effected without the use of cachet.) Possession is transferred to the buyer primarily to prevent opportunistic breach by the seller.

It should be noted that with respect to the traditional form of open cachet discussed in the text, there is generally no such thing as opportunistic breach on the part of the seller. (Although it is improper for the seller to show the stone to another buyer while it is still under cachet, the wrapper is signed across the deal to discourage this and make its violation known to the buyer.) If the seller receives a higher offer on the stone from someone who viewed it prior to consummation of the cachet, he can terminate the cachet by contacting the original cachet holder. However, it is customary for him to tell the original buyer the new offer and to give him the opportunity to match the new offer. This leads to a mini-auction with the stone being sold to the highest bidder.

[24] When goods are traded in private offices, a Bill of Sale taken out of a standard form book is eventually drawn up. Sometimes it is drawn up as soon as the deal is concluded and before the buyer leaves with the stones. However, it is frequently sent by the seller after the buyer has left with the stone but before he has paid in full. Dealers explain that when they really trust the person they are trading with they do not, at the time of "contracting," attach any real importance to this writing. Traditionally, the bill of sale has been viewed as a mere formality used primarily for accounting purposes.

[25] If the sale was concluded in accordance with the rule of open cachet the cachet parcel is included in the bag with the stone and the official weight slip.

of the slip exists and it is retained by the seller. If a dispute later occurs the Club's dispute resolution bodies consider the slip to be definitive evidence of both the stone's weight and the existence of the transaction. Even if this writing were sufficient to satisfy the requirements of the New York Statute of Frauds, it could not be sued on in either New York State court or Federal Court[26] since the Club membership agreement requires that all disputes between Club members be arbitrated, and this agreement has been upheld as binding.

c. The Club's Private Arbitration System:

Around 150 disputes per year are submitted to the DDC's arbitration system. Of these, it is estimated that 85% are settled during the mandatory pre-arbitration conciliation procedure. Although there has been a slight increase in the number of arbitrations in recent years, this is attributed primarily to the increase in Club membership rather than to a deterioration of trade ethics.

The DDC's procedural rules clearly reflect the industry's preference for the voluntary resolution of disputes. The By-Laws are structured to give the parties control over the dispute resolution process and to create financial incentives to settle. An important feature of the arbitration system is the secrecy of the proceedings.[27] The arbitrators are not required to make findings of fact and do not produce written decisions explaining their reasoning. As long as judgments are complied

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[26] See Zilbershatz v. Adler, SDNY, Slip Op. No. 83 Civ. 307 (Feb. 25, 1983) (holding that the DDC arbitration procedure does not have "a sufficient link to state action or state law to establish federal jurisdiction.")

[27] As Part III of this article will elaborate, one of a diamond dealers most important assets is his reputation. Consequently, when a diamantaire is involved in a dispute, he does not want this to become publicly known.

with, the existence of the arbitration as well as its outcome are officially kept secret.

1. *Procedural Aspects of Arbitration*

There are two dispute resolution bodies in the DDC, the Floor Committee[28] and the Board of Arbitrators; both are composed of Club members who are elected for 2 year terms. Before a dispute is referred to arbitration, the Floor Committee must find that a material issue of fact exists. The standard used is similar to the common law's standard for granting summary judgment.

Any member[29] of the DDC who has a claim "arising out of or related to the diamond business,"[30] against another member has

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[28] The Floor Committee has the authority to exclude a member from the trading hall for up to 20 days and/or impose a fine of up to $1,000 when the member "fails to meet his commercial obligations to another member and no material issue of fact is involved or a member causes a disturbance or conducts himself in the clubrooms in a manner unbecoming a member of the club." DDC Arbitration By-Laws: Article VIII, Sec. 7B1. A decision of the Floor Committee may be appealed by filing a written request and paying the $100 appeal fee. Unless the panel finds that a material issue of fact exists and recommends that the case be referred to arbitration, the decision of the appeal panel is final. Neither the Floor Committee nor the appeal panel are required to make any findings of fact.

[29] Although the DDC arbitration system is operated primarily for the benefit of Club members, non-members who have a dispute with members often request that the Club hear their case. In most instances the Board will grant their request as long as the member consents and both parties sign an agreement to arbitrate. There are a number of reasons why non-members who have disputes with members might request that a dispute be arbitrated: (1) If the non-member knows he is in the wrong, yet the parties are unable to agree on a settlement, it is to his advantage have a neutral third party assesses a penalty and for him to comply. This may enable him to minimize the reputation cost of his breach, since arbitration awards are kept secret if the judgment is promptly paid. Although the results of arbitrations sometimes become known through gossip, as long as the individual is not frequently involved in such controversies, the damage to his reputation is likely to be contained. (2) If the non-member thinks he is in the right it is to his advantage to have the dispute arbitrated since even if it was the type of dispute a court would decide, arbitration is cheaper and faster, and, as discussed above, the arbitration Committee has the ability to place unique pressures on the member to pay promptly. Although Club members are not obligated to submit disputes with nonmembers to arbitration, when arbitration is requested by the non member they will sometimes agree in order to avoid the transactions and reputation costs of going to court.

[30] DDC Arbitration By-Laws: Article VIII, Sec. 1a.

the right to file a written complaint against the member who must then submit to DDC adjudication. At the time he files the complaint, the plaintiff must pay the arbitration fee,[31] but at the conclusion of the case, the panel "shall decide which of the litigants shall pay the arbitration fee and the expenses which were necessarily incurred, and. . .may refund the arbitration fee or any part of it."[32] Arbitrators are required to render their decision within 10 days of the hearing.

Arbitration awards can be appealed if notice of appeal is filed with the Board of Directors within 10 days of the parties' receipt of the judgment. The appellant must pay a fee of three times the original arbitration fee and "deposit cash or sufficient security to cover the amount of the judgment."[33] The Appeals Board is composed of five arbitrators who did not hear the original case and it too is "under no obligation to specify any findings of fact which are reversed or modified nor, set forth any new findings of fact."[34]

Although the decisions of the Arbitration Board can be appealed to New York State Court under N.Y. CPLR §7501, arbitration awards can only be vacated for procedural irregularities, the substantive rule of decision is not reviewed.[35]

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[31] The By-Laws set the arbitration fee at: $25 for the first thousand dollars of the claim, $10 for each succeeding thousand dollars up to ten thousand dollars, and $5 for each additional thousand dollars.

[32] DDC Arbitration By-Laws: Article XII, Sec. 2

[33] DDC Arbitration By-Laws: Article XII, Sec. 15

[34] DDC Arbitration By-Laws: Article XII, Sec. 17

[35] New York CPLR §7501 provides that an arbitration award can be vacated for procedural irregularities such as an arbitrator engaging in an ex-parte communication, or a failure to allow the parties to be represented by counsel. See, e.g. Goldfinger v. Lisker, 508 N.Y.S.2d 159 (on a motion to confirm a DDC arbitration award the court granted a cross motion to vacate the award on the grounds that while the DDC By-Laws do authorize arbitrators

2. Substantive Aspects of Arbitration

The DDC Board of Arbitrators does not apply the New York Law of contract and damages; rather it resolves disputes on the basis of trade customs and usages, many of which are set forth with particularity in the Club's By-Laws, and others which are simply generally known and accepted. Although at first glance diamond transactions appear to be simple buy sell agreements, complicated controversies often arise, particularly in the sale of polished stones. In general, disputes fall into three main classes: those for which the trade rules prescribe an explicit remedy[36], those for which the trade rules prescribe no remedy

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to investigate the facts, ex-parte communications with arbitrators are not thereby sanctioned.) In addition, New York Law requires that the arbitration process be free from the appearance of bias. See e.g., Rabinowitz v. Olewski, 100 A.D. 2d 539; 473 N.Y.S. 2d 232 (2nd Dept 1984) (where the court ordered a stay of DDC arbitration and directed that the case be heard by an independent arbitrator after a letter surfaced in the Club which accused the plaintiff of being sympathetic to the Palestine Liberation Organization, since it was clear that a substantial injustice might result were the case heard by the predominantly Jewish DDC and there was the "appearance of impropriety and specter of bias among the DDC.")

[36] For example, the By-Laws provide that:(1) When a sale is consummated on a cost plus profit basis, the buyer has a right to demand proof of the cost. "This right terminates after the payment in cash, check or note of the amount agreed upon. However, payment is not considered as a discharge of responsibility whenever the buyer has any proof which shows the cost price of the merchandise to be otherwise than as stated;"DDC By-Laws: Article XIX, Sec.2 (2) When there is a gross error in quoting prices, a transaction may be voided; (3) "Whenever the sizes of the stones are not as set forth on the parcel paper and such deviation makes a price difference, then the buyer, immediately upon the completion of the transaction, has the option to cancel the transaction or to demand an adjustment of the price or of the size, whenever the latter is possible." DDC By-Laws: Article XIX, Sec. 3

In 1980 the By-Laws were amended to include special rules governing transactions in certificate stones. See DDC Arbitration By-Laws: TRADE RULES REGARDING CERTIFICATE STONES. They provide, for example, that "Once a stone and a certificate shall both have been examined by the Buyer and unconditional mazel given by the seller or his agent, the sale is final." When representations as to a stones properties are made in writing on a cachet parcel in lieu of presenting the gemological certificate, and a discrepancy between the representations and the certificate is discovered, the buyer has the right to void the sale. When a buyer asks that a stone be resubmitted to ascertain the accuracy of the weight noted on the certificate and the seller agrees to the reweighing, the buyer must pay the cost if the result is in accord with the original certificate. If the weight is not in accord with the original certificate, the seller pays the weighing fee and but are common enough that they are dealt with consistently according to widely known customs, and complex disputes which the arbitrators either decline to hear, or decide in accordance with rules of decision and damage measures that neither party can predict ex-ante.

The dispute resolution system in the diamond industry shows some sensitivity to concerns of institutional competence. Under its By-Laws, the Club has the right to refuse to arbitrate a claim when it does not arise out of the diamond business, or "(1) involves complicated statutory rights; (2) is 'forum non-conveniens' in that it is burdensome or inconvenient to handle the claim in the Club; (3) involves non-members; (4) has been conciliated, mediated, arbitrated or litigated outside the Club and/or the parties have sought remedies elsewhere; (5) is not in the ordinary course of commercial dealings."[37] When the Club refuses to hear a case, the parties are permitted to seek remedies outside the Club.

In complex cases that are neither explicitly covered by the Trade Rules nor dealt with according to established custom, it is difficult to determine what substantive rules of decision are applied. Arbitrators explain that they decide complex cases on the basis of trade custom and usage, a little

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the buyer has an option not to accept the stone. When a buyer requests such a reweighing and the seller refuses to submit the stone, the buyer may withdraw his offer. If a sale is contingent on resubmission of a stone for certification, then the seller must resubmit the stone. When there is a change in certification after resubmission as regards color, clarity or weight and the giving of "mazel" was conditional on recertification being the same as was initially represented, either party may void the transaction.

[37] DDC Arbitration By-Laws: Article XII, Sec. 1b. See, e.g., Finker v. The Diamond Registry, 469 F. Supp 674 (SDNY 1979) (where the DDC agreed to decide issue concerning the ownership of goods held on memorandum (consignment) but "refused to involve itself in the dispute concerning the trademark registration and alleged infringement.")

common sense, some Jewish law, and civil law legal principles (last). There are no general rules of damages. When calculating damages, the arbitrators look at the stone, consider the circumstances, and apply their business experience. Many dealers feel that the arbitrators have redistributive instincts. Dealers cite the unpredictability of the decisions as well as the arbitrators tendency to "split the difference" as an important motivation to settle their disputes on their own. This may be a reason why while 150 arbitration complaints are filed each year, only 30-40 go to judgment. The Arbitration Board is like a jury black box. The Arbitrators announce their judgment, but they neither make findings of fact nor explain their reasoning. The absence of explicit findings of fact and written opinions is a precaution to prevent people from complaining, rightly or wrongly, that they were biased, unfair, or relied on something that lacked probative value. Diamond dealers eschew arbitration for many of the same reasons that businessmen in general are wary of jury trials.

A person who is found to have breached an agreement or to have engaged in unethical conduct, in addition to compensating the other party for his loss, is sometimes ordered to pay punitive damages or a fine in the form of a donation to charity. Thus, unlike court awards, which while unpredictable are at least bounded by expectation damages, arbitration awards have a completely uncertain component. In one case a dealer falsely accused another dealer of stealing a stone. The accuser subsequently remembered where he had put the stone and apologized to the other dealer. However, as the incident had become widely known throughout the Club, the wrongly accused dealer brought an arbitration action against the owner of the stone for impugning his good name. The Board ordered the man to make a full public apology and make a fifty thousand dollar donation to a Jewish charity.

3. Enforcing Arbitration Judgments

The DDC By-Laws provide that "All decisions of arbitration panels including floor committee arbitrations which are not complied with within 10 working days, together with the picture of the non-complying member, shall be posted in a conspicuous place in the Club rooms."[38] This information is communicated to all bourses in the World Federation. As a condition of membership in the Federation, each bourse agrees to enforce the judgments of all member Bourses. Since most diamond dealers frequently transact in foreign bourses, this reciprocity of enforcement greatly increases the penalty for failing to voluntarily comply with an arbitration judgment.

The Arbitration Board can also suspend or expel a member for failure to pay a judgment or failing to pay his diamond related creditors without making special arrangements through the Club's private bankruptcy system.[39]

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[38] DDC Arbitration By-Laws: Article VIII, Sec. 26.

[39] The diamond industry has its own form of Chapter 11 bankruptcy. See DDC By-Laws: Article XX of the DDC By-Laws. Unlike the arbitration system which operates in place of a public trial, the DDC's bankruptcy rules and procedures do not supplant civil bankruptcy law; they provide instead a parallel set of rules that are mandatory for Club members: " Any settlements made outside of the jurisdiction of the Club do not absolve the debtor member's liability for suspension purposes." There is no such thing as "discharge" under the private bankruptcy rules, "All debtors must make provisions for the payment of one hundred percent (100%) of his/her debt;" debt is rescheduled on the basis of the dealer's ability to pay.

After the Club has been notified of a member's bankruptcy, the member is required to "turn over in escrow to the Diamond Dealers Club, Inc. his assets of any kind for distribution to his creditors," and a creditors committee is formed to effect the distribution. While bankruptcy proceedings

The remedy of suspension is more frequently used than the remedy of expulsion. Expulsion presents a classic end game problem. The expelled member may feel like he has nothing to loose by challenging the Club--he can challenge the Board's decision, file a private antitrust suit, or sue in tort for interference with business relations. However, the By-Laws provide that a member who was suspended or expelled may be readmitted after two years on the same terms as a new member. Although in theory this provision appears to be a partial solution to the end game problem, given the long waiting list of those who have already qualified for Club membership, and the subjectivity of the admissions process, it is unlikely that dealers are routinely readmitted under this provision. Furthermore, even if the admissions committee voted to readmit a dealer, whether or not he would be shunned would depend upon the original reason for his expulsion. The By-law provision was

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are taking place the debtor is not allowed to enter the club room unless given explicit permission to do so by the Club Committee. (See Matter of Marcus [MVAIC],. 29 Misc. 2d. 573, In Matter of Paul Verstandig v. Diamond Dealers Club, Inc. 23 A.D. 2d 547 (1965) (upholding "the Club's action in suspending petitioner as a member for the breach of the Debtor-Creditor General Rules of the Club.")

Similarly, "where the debtor has requested a settlement with his creditors for any sum less than one hundred percent (100%), and has not complied with the action required of him as set forth in this article," he may be suspended or expelled from the Club. If the member does not make arrangements for restitution and is expelled from the club his name is circulated (on agree slips) to clubs and courses in the World Federation and posted on their bulletin boards. The bankruptcy rules are strictly enforced since the industry depends on credit reliability.

After conclusion of bankruptcy proceedings, "A majority of the Board of Directors may reinstate any suspended member should they feel s/he has conducted her/himself as a bonafide debtor and has made provisions for the payment of one hundred percent (100%) of his/her debt." Formerly bankrupt members who comply with he Club's bankruptcy rules are often readmitted under this provision.

probably included to enable the Club to avoid charges of intentional interference with business relations. [40]

Under New York CPLR §7501, binding arbitration awards can be confirmed in civil court. If this is done, the judgment has the same force and effect as a court award. However, in practice, it is rarely necessary for a party to a DDC arbitration to seek confirmation of a judgment. Unlike arbitration awards which are officially kept secret, a confirmation proceeding in court would quickly become public knowledge, and the dealer against whom the judgment was entered would suffer severe damage to his reputation. Furthermore, if a member refuses to pay a judgment and the party who prevailed finds it necessary to obtain a court enforcement order, the DDC By-Laws require the losing party to pay an additional 15% of the award to cover legal expenses. Another enforcement mechanism sometimes invoked by the Arbitrators is to institute a proceeding in Jewish Rabbinical Courts against the party who refuses to comply. Because these courts have the authority to ban an individual from participation in the Jewish community, this a powerful threat against Orthodox members of the diamond industry.

Part III: An Economic Analysis of the Extra-legal Contractual regime.

a. The Reasons that Executory Agreements are Needed

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40 In the wake of an antitrust suit brought against the Club in 1951, challenging the Club's practice of refusing to deal with Germans after World War II, an Article was added to the By-Laws that cautions members not to engage in any behavior that can be construed as being in restraint of trade.

In order to understand the contractual paradigms used by diamond dealers it is important to briefly consider why executory agreements, contracts, are used at all. For many transactions, simultaneous exchange is advantageous. It reduces the riskiness of the transaction, decreases transaction costs by eliminating costly and time consuming negotiations over payment terms, eliminates the need for going through the formalities of cachet, and, most importantly, enables dealers to trade with people about whose reputation they have little information. Simultaneous exchange is facilitated by the presence of a major diamond financing bank in the same building as the DDC. In addition, the seven other banks that extend credit to New York dealers are located nearby.

Although simultaneous exchange frequently occurs, particularly in small scale transactions, in many transactions it will be neither possible nor beneficial. In the diamond industry there is a great need for credit. As explained earlier, even the largest sightholders need credit to finance the purchase of their boxes of rough. Similarly, non-sightholders also acquire most of their stones on a cycle that follows, but lags behind, the schedule of sights, and therefore need credit to enable them to purchase enough stones to keep their cutters working until the next sight. Access to credit is also essential in the market for polished stones. Because polished stone sales are highly seasonal, with 30-40% occurring in November and December, access to credit is needed to avoid a cash shortfall.

After the diamond crash of the early 1980's, banks became more reluctant to finance diamond dealers, particularly small dealers and manufacturers. As a consequence, the term of payment came to be the most flexible and haggled over provision of a diamond contract. The most common terms are immediate cash payment, thirty day terms and sixty day terms. This corresponds roughly to the time it takes to manufacture a stone which depending on the cut, the stone, and the skill of the manufacturer, generally takes from four to six weeks. The close correlation between cutting time and the length of the payment terms suggests that sellers generally finance most, if not all, of the buyer's (manufacturer's) cash gap.

The market for rough and polished diamonds functions not only as a commodities market but also as an implicit capital market.[41] One possible explanation for the extension of credit by sellers is that most sellers have better and less expensive access to outside capital than most buyers. Many of the most important sellers are also DeBeers sightholders. The mere fact that an individual is a sightholder is a signal to the bank that he is a good credit risk. The Cartel not only closely monitors the business activities of its sightholders, it also provides business planning advice. If the Cartel's suggestions are heeded, the sightholders are rewarded with a more profitable selection of stones in their boxes. Thus, banks prefer to lend to sightholders.[42]

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[41] The practice of giving goods on consignment (memorandum) is another way of effecting an implicit loan.

[42] By lending to sightholders banks do not have to incur the cost of valuing inventory collateral as they would if they leant to non-sightholders. Because valuing diamonds requires expertise in gemology that is costly to acquire and time consuming to exercise (particularly since diamantaire's inventories are constantly changing) banks can lend to sightholders at an interest rate below the rate that they would have to charge if they extended loans to non-sightholders.

Unlike banks, sightholders are industry insiders; they have good information about dealers' reputations and transact with the same people on a repeat basis over a long period of time. It is thus cheaper for sightholders to monitor dealers' reputations and credit worthiness than it is for banks.[43] Consequently, it is likely that sellers can offer terms (and an implicit interest rate) that a buyer would prefer to simultaneous exchange financed through a short term bank loan.[44]

The economics of the diamond industry suggest that there must be a way for dealers to make and enforce executory contracts. Parts IIIb-d of this article discuss why the diamond industry has opted for legally unenforceable agreements over legally enforceable contracts and considers the two ways that these extra-legal agreements are enforced. Parts IIIe-h consider the efficiency implications of these arrangements and discuss the substantive and procedural reasons that arbitration is preferred to litigation.

b. The Choice Between Extra-legal Agreements and Legally Enforceable Contracts.

One line of analysis used to explain market transactors' choice between legally enforceable contracts and legally unenforceable contracts focuses on the transaction costs of negotiating and drafting legally enforceable agreements. However,

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[43] Because sellers have better information about an individual dealer's operations, they are able to price the implicit loan more accurately (that is, to price it according to an accurate estimate of the risk of default) than a bank could.

[44] However, the Merchants Bank of New York is attempting to create a market niche for itself by creating a special group of gem experts who become involved in the day to day operations of the industry (thereby gaining access to intra-industry reputation information). The bank then extends short term loans to non-sightholder dealers. The bank's policy, however, is new and it is too early to assess its success.

it is not clear a priori that these costs are necessarily higher than those incurred in the formation of an extra-legal contract consummated with a handshake. Even if the cost of setting the terms of a commitment are lower for extra-legal than legally enforceable contracts, the total cost of entering into a legally unenforceable contract may be higher. Because the ability of the promisee to enforce an extra-legal contract depends upon the posting of a reputation bond by the promisor, even before negotiation over the terms of the agreement begins, each of the parties must bear the "information cost" of determining whether the other party is trustworthy.[45] This cost may be substantial and will depend, at least in part, upon the size, structure, and terms of the proposed transaction as well as on the likelihood that the parties will have occasion to deal with one another again in the near future.

In general, the magnitude of pre-contract transaction costs incurred in the formation of extra-legal contracts will depend on how common such contracts are in the relevant market. In the diamond industry, extra-legal contracts are the dominant contractual paradigm. Consequently, the industry is organized to

45 Although in the typical diamond transaction, the buyer takes possession of the stone and promises to pay the seller at some time in the future, the buyer must still obtain information about the seller's reputation. Using lasers and chemical processes, diamonds can be treated to artificially enhance color and disguise flaws. Small flaws and differences in color dramatically affect the value of a stone. However, many of these "treatments" cannot be detected without sophisticated equipment. Although in theory buyers could have every stone evaluated by a gemological laboratory to make sure that it had not been altered, this would be prohibitively time consuming and expensive. Nevertheless, if a dealer purchases a "treated stone" and sells it to somebody else who discovers the stone's treatment, he can be taken to the arbitration panel for failing to disclose the treatment. The panel would then have to decide whether the dealer knew or reasonably should have known of the stone's treatment. The reputation of the person he purchased the stone from would be an important factor considered by the arbitrators.

minimize the cost of obtaining information about dealers' reputations.[46] In addition, while formalities[47] elaborate enough to serve the "channeling," "cautionary," and "evidentiary"

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[46] See text supra at 6-11.

The flow of information about reputation is further facilitated by the presence of a large number of brokers in the market. Brokers can gather information about individuals' reputations for trustworthiness at a lower effective cost than can individual buyers and sellers since their investment is less asset/transaction specific. When an individual buyer and a seller invest in acquiring information about one anothers' reputation only to find that the buyer needs a particular size stone that the seller does not have, the parties have lost part of their investment. While it is true that the information they acquired may be useful to them in the future, the value of reputation information (particularly among younger dealers) diminishes over time as its accuracy decreases. In contrast, a broker who has this information can shop around immediately for another buyer for the stones the seller has on hand, and can seek out an alternative source of supply for the buyer.

Despite their informational advantage, there are a variety of reasons why brokers do not play a larger role in the market. Information about "trustworthiness," unlike consumer credit information, is difficult to communicate in objective terms. What is ethical behavior to a thirty year old dealer, may be an abhorrent business practice to a sixty year old dealer. One Israeli dealer explained that within the bourse there are small trading groups whose members trade primarily among themselves. The groups are defined by their standards of what constitutes fair and ethical trading. In addition, even when they participate in brokered transactions, the individual buyer and seller still have to invest in acquiring information about the broker's judgment and reputation. However, this is cheaper since it is less transaction/asset specific. Once a dealer determines that a broker has good judgment, he has access to many other dealers whose reputations he need not inquire into directly. Another reason that brokers do not participate in more deals is that the institutional structure of the industry is designed to reduce the cost of acquiring information about reputation, so that the brokerage fee of 1% of the price may be prohibitively high particularly on low profit margin transactions. In addition, a seller who gives a broker a stone to sell on memorandum will frequently incur the transaction cost of drawing up a legally enforceable explicit contract. See text infra at 59. However, as the geographical dispersion of the industry increases, they are becoming more important.

[47] Although a substantial cost generally associated with the use of legally enforceable contracts is that they "must satisfy the various formal . . . and substantive requirements for enforceability," (D. Charny,"Implicit Contracts" Rough Draft Distributed for Discussion at HLS Law and Economics Workshop, 1989 at 23. Cited with permission. Forthcoming as "Nonlegal Sanctions in Commercial Transactions," 104 Harv. L. Rev. (1990)) even more formalities may have to be expended in the formation of an extra-legal contract. Particularly when forfeiture of the bond requires a measure of social ostracism or reputational damage, the agreement must have been attended by enough formalities to signal to other members of the relevant group that an agreement had taken place.

functions of formality are used,[48] they impose only minimal additional cost.

Economic explanations for the absence of legally enforceable written contracts that focus on the transaction costs incurred in preserving an agreement in an integrated writing are plausible in some markets, but do not fully explain the diamond industry's preference for an extra-legal contractual regime. In the diamond industry the types of contingencies that can arise in a typical transaction are well known as are the customs and usages of the trade. Consequently, it would appear that standardized form contracts, that would ensure legal enforceability at relatively low drafting costs, could be used in most transactions.[49] Nevertheless, the use of such contracts is not observed.

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48 See L. Fuller "Consideration and Form," 41 Colum. L. Rev. 799 (1941) (Distinguishing (1) the channeling function of contract in which "form offers a legal framework into which the party may fit his actions. . . it offers channels for the legally effective expression of intention;" (2) the "cautionary or deterrent function by acting as a check against inconsiderate action;" (3) the evidentiary function "of providing 'evidence of the existence and purpose of the contracts in the case of controversy.")

49 The widespread use of weight slips, invoices, and bills of sale, suggests that the additional transaction costs of using standard form contracts would not be prohibitively high.

However, even if legally enforceable contracts were widely used and could be inexpensively drafted, dealers would still need to incur at least some of the costs of acquiring information about the reputations of their trading partners. First, over a certain range of transactions, it would never be worthwhile to litigate a claim even if breach occurred. Litigation costs, delay, the opportunity cost of capital and the difficulty the court has in valuing diamonds, make litigation an unattractive alternative. Consequently, a legally enforceable agreement would have no value and any resources expended in its creation would be a dead weight loss. *To the extent that the cost of enforcing a contract in court is greater than the expected benefit, even legally enforceable contracts have an implicit, extra-legal, component.* Thus, the dealer would need every bit as much information about the other party's reputation as he would if the deal were simply consummated with a handshake. Second, vulnerability of possession has traditionally been a motivating force behind the creation of many customs and institutions in the diamond industry. Diamonds are small, can easily be concealed, and can quickly be cut into new shapes making stolen goods impossible to identify. Consequently, before dealers even admit one another to their offices or allow their stones to be examined, they must trust one another at least to some extent-- that is, even if written and fully specified contracts existed, many of the the transactions costs of acquiring information about reputation would have have to be incurred anyhow. Although

Inherent in the transactions costs approach is the idea that if fully specified explicit contracts could be drafted at little or no cost, legally enforceable contracts would be preferred to extra-legal agreements. However, in the diamond industry, a legally enforceable agreement, even one that can be inexpensively drafted, is not usually considered a positive "good." Because secrecy is highly valued,[50] a person who exposes the workings of the business to the public will suffer a loss in the value of his reputation. Prior to the formation of an agreement, both the buyer and the seller understand that circumstances beyond their control might lead them to breach a contract. Both are litigation averse. By not putting their agreement in a legally enforceable writing, they insure that whatever pecuniary losses they may incur in the transaction, they will not incur the reputation cost associated with the breaking of the secrecy norm. Historically, preservation of the secrecy norm is one of the primary reasons that the industry uses extra-legal agreements rather than legally enforceable contracts.[51]

Although the strength of the secrecy norm has been diminishing in recent years, there are additional reasons why extra-legal contracts are more desirable to diamond dealers. In general, where there are costs or factors that the courts are

buying insurance might be an alternative way to protect against the risk of loss due to theft, policies would probably be unavailable or prohibitively expensive due to problems of moral hazard.

[50] From the perspective of market insiders, if a norm of secrecy can be effectively enforced it is beneficial since it creates high barriers to entry and thus decreases competition. Enforcement (not dealing with those who violate the norm) is inexpensive since monitoring costs are low-- whether or not an individual breaks the secrecy norm is, by definition, immediately obvious.

[51] For a discussion of the religious origins of the secrecy norm, See notes 69-70, at 41.

systematically unwilling to recognize or take into account in setting damages, either for doctrinal or public policy reasons, but that ex-ante both parties perceive as being important, the parties are more likely to opt for extra-legal contracts. The same is true in situations where the courts refuse to apply a rule of decision preferred by the parties or, in interpreting agreements, refuse to do so in light of the prevailing custom. In sum, extra-legal contracts are more likely to become an industry norm in situations where traditional contract remedies are likely to lead to inefficiently high levels of breach of contract, and the market is organized in a way that makes other methods of enforcing these agreements possible. In the diamond industry both of these conditions are met.

c. The Shortcomings in the American Legal System and the Common Law of Damages that Make Extra-legal Contracts Desirable to Diamond Dealers.

If commercial transactions in the diamond industry were governed solely by explicit legally enforceable contracts under which the promisee could recover expectation damages in the event of breach, the market would be characterized by frequent inefficient breach of contract. The sources of this inefficiency are the uncertainty of recovery, the inability of the courts to accurately calculate damages, the length of time it takes to obtain a judgment, and, in some instances, the fact that many diamantaires do not have ready access to capital markets.

In American courts, in a suit for breach of contract, expectation damages[52] are the upper bound of what the promisee can

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[52] The classic definition of expectation damages is set out in Hadley v. Baxendale, where the court held that the promisee could recover such damages "as may fairly and reasonably be considered. . . arising naturally, i.e., according to the usual course of things, from such breach of contract

recover and what the promisor can be ordered to pay.[53] In theory, expectation damages are supposed to put the breached against party in the same position he would have been in had the contract been performed. In the absence of large reliance expenditures, expectation damages are the best damage measure if the goal is to induce efficient breach of contract-- that is, to provide a structure of damages such that the promisor will perform in all cases where the cost of performance to the promisor is less than the value of his performance to the promisee.[54]

In practice, however, because recovery is uncertain,[55] expectation damages (even when perfectly calculated) neither

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itself. . . [as well as an amount] as may reasonably be supposed to have been in the contemplation of both parties at the time they made the contract, as the probable result of the breach of it." However, economic theory suggests that the broader measure of expectation damages authorized by Hadley will rarely be awarded. If damage measures are viewed as substitutes for negotiating complete contingent contracts, it is unlikely that courts will ever have occasion to award this broader measure since the cost of specifying future contingencies in sufficient detail to recover full consequential damages is likely to be just as great as the cost of negotiating additional contingency terms. If the parties are willing to incur this cost, they will likely want the additional benefit of explicitly spelling out the terms of their understanding.

[53]Although courts sometimes uphold so-called "liquidated damages" clauses which specify the amount to be paid in the event of breach, they do so only if the amount is "reasonable," that is, not too different from the expectation measure of damages. Otherwise, the clause is deemed to be a penalty and is invalidated in its entirety. See note 58 infra at 33. The main benefit of liquidated damages clauses is that they enable the parties to the contract to come to an explicit understanding about how to allocate risk and to deal with the consequences of non-performance. However, in reality, liquidated damages clauses are not much more certain than court imposed damages measures. Individual judges and courts differ greatly in their attitude towards liquidated damages clauses; the expected value of a liquidated damages clause is, in any given contract, quite uncertain ex-ante.

[54] If the cost of performance to the promisor is greater than the value of the performance to the promisee, both parties can be made better off if the promisor pays the promisee expectation damages plus a small amount and does not perform.

[55] In a suit on a contract there are three main sources of uncertainty: the applicable law may be unclear, the meaning of the contract or of some its terms may be susceptible of conflicting interpretations, or the facts of the case may depend entirely on the credibility or availability of witnesses. The presence of uncertainty, reduces the expected cost of breach to the promisor by either making the promisee's recovery less certain, or reducing the measure of expectation damages.

make the promisee whole, nor force the promisor to take into account the full cost of breach to the promisee.[56] In considering whether expectation damages will in fact lead market transactors to make efficient breach decisions, it is important to consider from the ex-ante, that is pre-contract, point of view of the parties what the present value of the expectation remedy is to both the promisee and the promisor. In deciding whether to breach a contract, the promisor compares the expected cost of having to pay expectation damages-- that is the probability that the court will find that breach occurred multiplied by the value of the expectancy that would be awarded, plus legal costs-- to the benefit of breach. To the extent that the promisor's expected cost of having to pay expectation damages is less than the amount required to put the breached against party in the same position he would have been in had the contract been performed, the promisor will have an incentive to breach contracts where, from a market wide perspective, it is inefficient for him to do so. The greater the divergence between expected cost to the promisor of breach, and the actual loss suffered by the promisee, the more frequently inefficient breach will take place.

In addition to the uncertainty of recovery, the manner in which courts actually calculate expectation damages further reduces the ex-ante expected cost of breach to the promisor. Thus, even if courts are well functioning and are able to accurately determine whether or not breach has occurred, the ex-ante present value of the "expectation damages" that could be recovered by the

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[56] The extent to which expectation damages and the rule against penalties constitute a defect in the legal contractual regime, varies from case to case and depends on: (1) the type of promise and (2) the actual circumstances of the promisee at the time of breach.

promisee in the event of breach will almost always be substantially less than the value of performance to the promisee.

In calculating expectation damages, courts are reluctant to award compensation for lost profit, since in most instances it is considered an inherently speculative quantity. In a diamond transaction, lost profit would be extraordinarily difficult for a court to calculate since it is highly idiosyncratic. The profit a dealer can make on a rough stone depends intimately on his network of contacts, his skill as a cutter, and his ability to choose a cut for which market demand is high.[57] The same is true of polished stones, but to a lesser degree.

In calculating expectation damages, courts award interest to compensate the promisee for the cost of doing without the money during the pendency of the controversy. However, interest will fully compensate the promisee only if the unavailability of funds did not affect his ability to enter into subsequent transactions. That is, if the promisee had access to credit on reasonable terms during the relevant time period. The typical diamond dealer does not have ready access to capital or excess cash on hand. Having a portion of his capital tied up during the three years it takes a law suit to progress through the New York Courts could cause a dealer extensive financial harm that would not be taken into account in the final calculation of damages.[58]

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[57] Similarly, when a breach of a promise to pay money is at issue, it will be difficult, if not impossible, for a court to determine the value of the profit a dealer would have made subsequent to the breach had the dealer had the dealer been able to invest the money he was owed-- the value of business opportunities forgone is an inherently speculative quantity.

[58]In general, expectation damages take into account the cost of money. Interest is awarded to compensate the promisee for the cost of doing without the the money during the pendency of the dispute, and, ex-ante if the promisee believes that the interest rate that a court would award in the event of breach is lower than the true cost of capital to him, he will

As demonstrated above, even if diamond dealers used legally enforceable contracts under which even "full" expectation damages

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demand an upward adjustment of the the contract price to compensate him for this contingency (or, the parties might include a clause that specified the interest to be paid in the event that a court finds that breach occurred.) However, while the price term of a contract can adjust to take into account the cost of money, the price term will not be able to fully take into account the consequences of the almost complete unavailablity of funds. This is likely to be the case in the diamond industry. As explained in the introduction to Part III of this article, sightholders are the only industry participants who have ready access to capital. Other dealers must rely on credit to finance their purchases. Consequently, in a transaction between two non-sightholders, if the promisee is not paid, it is unlikely that he will be able to borrow money during the pendency of the dispute. If the amount owed is large, it is quite possible that he will have to suspend operations until he is paid. In the New York diamond market which specializes in the largest and highest quality goods, this will often be the case, particularly for mid-size dealers who operate on a tight cash flow margin. In any event, the promisee will lose the profit on the business opportunities that the unavailability of capital required him to forgo, a quantity that a court would have great difficulty determining.

One possible way of contracting around these difficulties would be to include a clause making the promisor liable for all consequential damages suffered by the promisee. However, because consequential damages can be enormous, are highly unpredictable, and will depend largely on actions taken by the promisee subsequent to the agreement, it is unlikely that a business man would agree to them. Another possibility would be to include a liquidated damages clause. The validity of a liquidated damages clause is governed by UCC §2-718 (1) which provides that: "Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach. . .A term fixing unreasonably large liquidated damages is void as a penalty." In Equitable Lumber Corp v. IPA Land Dev. Corp, 38 N.Y.2d 516, 381 N.Y.S.2d 459, 344 N.E.2d 391 (1976) the court held that even if a liquidated damages clause "satisfy[s] the test set forth in the first part of §2-718(1), a liquidated damages provision may nonetheless be invalidated under the last sentence of this section if it is so unreasonably large that it serves as a penalty rather than a 'good faith' attempt to pre-estimate damages." In a diamond transaction it would be difficult to arrive at a measure of liquidated damages that a court would view as a "good faith' attempt to pre-estimate damages." For example, it is likely to be the case that at the time of contracting non-payment of the contract price would not have bankrupted the promisee. However, if the promisee subsequently came upon a very profitable business opportunity and made a large investment in reliance on being paid and then was not, a court evaluating the reasonableness of the clause from a time of contracting perspective, or trying to determine whether the clause was a "good faith" attempt to pre-estimate damages," might view it as a penalty and invalidate it in its entirety.

Thus, in the largest transactions there will be many situations in which, due to the unavailablity of capital, the promisee will not be adequately protected by the availability of expectation damages in a suit on the contract. Similarly, in small to medium size transactions, the cost of litigating the dispute relative to the amount at stake, would render the ability to legally enforce the contract of little value to the promisee. However, over a narrow range of medium size transactions, it is possible that a regime of legally enforceable contracts would work reasonably well.

could be recovered, there would still be inefficiently high level of breach in the market. This suggests that legally enforceable contracts would not necessarily be the most efficient (Pareto preferred) way of concluding transactions in diamonds.[59]

Although the divergence between the expected cost of breach to the promisor and the actual loss suffered by the promisee is likely to be particularly large in the diamond industry, this divergence is present to some extent in every commercial transaction. A suit for breach of contract is a way for the promisee to control the damage he suffers; it does not make him whole. In a now famous study[60], McCauly found that even among businessmen who use legally enforceable contracts, there was a tendency to renegotiate contracts when unforeseeable contingencies arose and to settle disputes rather than resort to litigation. Because expectation damages never fully compensate the promisee, all business contracts have an implicit, extra-legal, term which captures the value of the promisors' reputation. [61]

In practice, a significant portion of most commercial contracts are backed, at least in part, by a reputation bond. What is unique about the diamond industry is not the importance of

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[59] Although liquidated damages clauses could be used to reduce the incentive for the promisee to engage in inefficient breach of contract, they will usually be held to be "unreasonable" to the extent that they depend on factors that the court cannot observe or that the court could not take into account in setting expectation damages. Furthermore, inclusion of a liquidated damages clause would greatly increase the pre-contract cost of negotiation and would be expected to reduce the number of transactions that take place.

[60] Stewart MaCaulay, "Non-Contractual Relations in Business: A Preliminary Study," 28 Am. Soc. Rev. 55 (1963).

[61]Thus, conceptually, in a typical commercial contract, the value of the reputation bond posted by the promisor that is necessary to induce efficient breach decisions, is the difference between the pre-contract expected value of expectation damages to the promisee, and the actual damage (subjectively defined) that the would be suffered by the promisee in the event of breach. In practice, these factors may also be taken into account in setting the price term of the agreement.

trust and reputation in commercial transactions, but rather the extent to which the industry is able to use reputation/social bonds at a cost low enough to be able to create a system of private law which enables most transactions to be consummated and most contracts enforced completely outside of the legal system, thereby avoiding most of the cost and deadweight efficiency loss of settling disputes through the legal system. This is accomplished in two main ways: (1) through the use of reputation bonds; (2) through a private arbitration system whose damage awards are not bounded by expectancy damages, and whose judgments are enforced by both reputation bonds and social pressure.

d. Reputation Bonds as a Way of Enforcing Extra-legal Contractual Commitments

The typical diamond transaction involves the posting of a "reputation bond."[62] A reputation bond has an actual market value.[63] The total value of an individuals' reputation is a function of the degree to which he possesses those attributes that other dealers consider important in business relationships such as honesty and a record of prompt payment of debt. In the diamond industry, reputation bonds are, in practice, the sole enforcement mechanism in transactions between dealers who are not members of a bourse. In transactions between bourse members, agreements can also be enforced in a proceeding before the bourse's Board of Arbitrators which has the authority to award damages and to suspend or expel members for non-compliance with its judgments.

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[62] In the context of diamond transaction, the reputation bond functions in place of the state's power to enforce judgments rendered by civil courts. In other contexts, reputation bonds have been advocated as a replacement for government regulation.

[63] The reputation bond posted in a given transaction has a value equal to the present value of the profit on future transactions that will not take place if the promisor breach less the promisors' ability to cover.

Reputation bonds, however, are the primary reason that the arbitration tribunal's decisions are obeyed; they are essential to the bourse's ability to enforce its judgments. The main function of both the Club and its arbitration system is to enhance the functioning of reputation bonds.

Transactions between members of the same trading community also involve the posting of what has been described as a "psychic/social" bond. There are two types of social bonds. Primary social bonds are similar to reputation bonds in that they have a market value. When a primary social bond is sacrificed, a dealer's ability to communicate information about his reputation and to obtain information about business opportunities is diminished. In contrast, secondary social bonds, in which "the bond posted by the promisor may lie in the prospect of . . . emotional or moral loss if the enforcer of the bond determines that the promisor has breached: loss of opportunities for important or pleasurable associations with others, loss of self-esteem, feelings of guilt, a desire to think of oneself as trustworthy and competent,"[64] may have a value to the individual on a personal level, but their loss often will not have a direct economic impact on the promisor. Although secondary social bonds are becoming less important in the diamond industry, vestiges of their former importance remain. The Diamond Dealers Club still functions like an old fashioned mutual aid society. It has kosher restaurants for its members. Social committees are organized by neighborhood to visit sick members and their families and a Jewish health organization provides emergency medical services. There is

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64 Charny at 7

a synagogue on the premises and contributions to a benevolent fund are required. Group discounts on packaged family vacations are also available so that members' families can travel together during the month that the bourse is closed. In addition, the Board of Directors has the discretion to make charitable contributions of up to 5% of the total annual income of the organization.

In considering the theory of reputation bonds, it is important to keep in mind that the Club's ability to enforce its arbitration judgments, whether through fines, suspension, or expulsion, depends on its ability to harness the force of a reputation bond and that the DDC can only enforce its judgments if non-compliance results in forfeiture of a type of reputation bond that is recognized and given value by market forces.[65]

1. The Theory of Reputation Bonds.

Reputation bonds are generally assumed to be effective only within geographically concentrated homogeneous groups who deal with each other in repeated transactions over the long run. However, Professor Charny has identified another set of conditions

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[65] In the early 1980's the Board of Directors of the DDC exercised their authority to expel a member from the Club for making public statements that tended to cast the industry in a negative light. They expelled Martin Rapaport for saying to the press, "diamonds, ethics, Feh! If the devil himself showed up they would sell to him." However, the real reason the Club wanted to expel Rapaport was that they were opposed to his price list. See note 12 Supra at.9. They also brought anti-trust suit against him for price fixing and asked a Jewish court to issue an injunction barring him from any further participation in the Jewish community until he ceased publishing the list. The attention generated by the suit led the FTC to initiate an investigation to determine if the Club itself was in restraint of trade. Although the FTC instituted a full scale investigation of the Club, it was later dropped. Rapaport himself settled with the Club on undisclosed terms and was readmitted as a member.

Today Rapaport has a strong base of support at the Club: he is a member of the Board of Arbitrators and his price list is an accepted fixture in the international diamond trade. Rapaport was not expelled for breaching contracts or failing to meet his commercial obligations; consequently the Club was unable to use its power to exclude him from the industry. The norms of the diamond industry only work when they capture information that the market values.

that will enable a reputation-bond based extra-legal contractual regime to function. He explains that even large scale markets based on reputation bonds will be feasible when " technology . . . makes it cheap to convey information to a large group of transactors, such as computers used to monitor credit worthiness, or mass media used in advertising. . . [that is] when a thick set of informational intermediaries,"[66] exists. At the present time, the diamond industry is in transition; it is moving from a "homogeneous group" based extra-legal contractual regime, to one that relies increasingly on "information technology."

2. The Homogeneous Group Paradigm

In a given market, geographical concentration, ethnic homogeneity, and repeat dealing may be necessary pre-conditions to the emergence of a contractual regime based on reputation-bonds. However, as the diamond industry illustrates, these conditions are not required for the maintenance of such a system, particularly when the system has already demonstrated itself to be preferable(Pareto preferred), to the established legal regime.[67]

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[66] Charny at 47

[67] In his book, The Economics of Rights, Cooperation and Welfare,(Basil Blackwell, Oxford, 1986) Robert Sugden creates a model of exchange which demonstrates how, under certain conditions a strategy which results in co-operation most of the time can be a stable, though not unique, equilibrium, even when there appear to be incentives for individuals to be free riders, and transactors occasionally make mistakes (that is, breach unintentionally.) The game--"Reciprocity in the Extended Prisoner's Dilemma"-- is an adaption of the classic prisoner's dilemma model in which the following conditions hold: (1) The benefit to player 1 of player 2 refraining from defecting "b", must be greater than the cost to player 1 of refraining from defecting himself "c", and the same must also be true for player 2. (2) ø, the probability that a subsequent round will be played must be greater than b/c, since if this condition did not hold the expected gain from defection will be greater than any gain from alternative strategies. In the context of the diamond market, these conditions appear to hold. The probability that the transactors will have of occasion to deal with one another in the future, ø, is quite high and in any one transaction the dealers have no reason to think that they are dealing with one another for the last time. There are many aspects of the diamond industry which suggest that the condition that b > c will hold. For example, a diamond dealer generally operates on a slim cash

flow margin and has trouble getting access to capital. He routinely makes business decisions in reliance on getting paid on a particular date. If he is not paid, the harm he suffers can be far greater than loss of the amount he is owed. Non-receipt of payment might force him to breach a contract with another dealer which will in turn damage his reputation. It might force him into insolvency and result in his suspension from the club. Overall, he might be better off forgoing the benefit of opportunistic breaches and being able to rely on receipt of payments that he is owed. (Note: Although Sugden's model depends on repeat dealing, the information intermediary paradigm which is discussed in the text, demonstrates that this may not be necessary to the functioning of an extra-legal contractual regime.)

Sugden calls the strategy which leads to co-operation in most rounds "tit-for-tat," and defines it as follows: "A player following strategy T co-operates in the first round. In every subsequent round he makes exactly the same move ('co-operate' or 'defect') as his opponent made in the previous round. Notice that if two T-players meet, they co-operate in every round." He then goes on to discuss a similar strategy which also produces a stable, though not unique, equilibrium but allows for the possibility of mistake (non-opportunistic breach). He calls this strategy T1 and defines it as follows: "T1 starts from a concept of being in good standing. The essential idea is that a player who is in good standing is entitled to the co-operation of his opponent. At the start of the game both players are treated as being in good standing. A player remains in good standing provided that he always co-operates when T1 prescribes that he should. If in any round a player defects when T1 prescribes that he should co-operate, he loses his good standing; he regains his good standing after he has co-operated in one subsequent round. . . [T1] is clearly a convention of reciprocity: a person following T1 is willing to co-operate provided his opponent is willing to do the same. But it is also a convention of punishment. Suppose that in some round i your opponent mistakenly defects while you co-operate. Then he has breached the convention and for this round you have been made a sucker. The convention new prescribes that in the next round your positions should be reversed: he should co-operate while you defect. Then in round i+2 you both co-operate again." Sugden at 110-114. This result provides support for the conclusion of this paper that reputation bonds are not as monolithic as critics tend to assume. It is important to note, however, that in order for the tit-for-tat strategy to be an equilibrium, the players must, in the first round have some reason to think that if they choose a strategy of co-operation, their opponent will do the same. In the diamond industry, bourse membership is a signal to other market transactors that you accept the norm--co-operate with those who co-operate with people like you. Thus, the first round condition would be satisfied by bourse membership. It could also be satisfied by the word of mouth information about reputation that dealers rely on every day.

The responses prescribed by the tit-for-tat strategy correspond quite closely to the observed behavior in the diamond market. Diamond dealers only transact with people who they trust to co-operate with them. Furthermore, the "reputation market" appears to distinguish opportunistic breach from breach due to unforeseen circumstances. While dealers say they will be reluctant to transact with someone who breached a contract with them in the past, they consider the reason for the breach important. (Dealers explain that when non-performance is due to a circumstance that neither party could reasonably have foreseen, renegotiation is likely to take place.) Breach due to unforeseen circumstances corresponds to "mistake" in Sugden's model which, under his assumptions, is responded to by non-cooperation in a specified number of rounds (which results in a benefit to the breached against party--damages-- and harm to the defecting party--punishment) after which the pattern of mutual co-operation is resumed. Similarly, when a diamond dealer breaches a contract due to unforeseen circumstances, the promsiee is somewhat more reluctant to deal with him, but in time normal commercial relations resume. Although Sugden's model provides a useful explanation of why once a

In general, homogeneous group based extra-legal contractual regimes are more likely to arise when "preexisting or gradually evolving social relationships provide a basis for implicit [extra-legal] contracts without large additional investments in developing a bond. . .[since they are] incrementally less costly as implicit [extra-legal] contract mechanisms when they are parasitic on background habits or understandings built into the culture in which these bonds are formed."[68] Because the diamond industry has long been dominated by orthodox Jews, it was able to take advantage of the existence of these conditions. In the past, Jews formed a cohesive geographically concentrated social group in the countries in which they lived. Jewish law provided detailed substantive rules of commercial behavior, and the Jewish community provided an array of extra-legal dispute resolution institutions. The parallels between Jewish Law and even the modern organization of the diamond industry are striking. For example, under Jewish Law a Jew is forbidden to voluntarily go into the courts of non-Jews to resolve his commercial disputes with another Jew. Should he do so he is to be ridiculed and shamed.[69] Jewish law also provides rules governing the making of oral contracts and lays down rules for the conduct of commercial arbitration.[70] In the trade

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norm of "co-operate with those who co-operate with you" gains wide-spread acceptance it can become a stable equilibrium, it is necessary to look elsewhere for an explanation of how this convention, or norm of behavior came into being. See Text infra at 41.

[68] Charny at 45

[69] See M. Elon, The Principles of Jewish Law, Keter Publishing House, Jerusalem Ltd. at 20-21 ("A striking expression of the religious and national character of Jewish law is to be found in the prohibition on litigation in the gentile courts . . . to which the halakhic scholars and communal leaders attached the utmost importance. . . any person transgressing the prohibition was 'deemed to have reviled and blasphemed and rebelled against the Torah.")

[70] Like the DDC By-Laws, Jewish law requires a 3 man arbitration panel. In addition, like the DDC arbitrators in complex cases, these Jewish arbiters "generally based their of decisions on communal enactments.. . . trade

diamond industry, Jewish law provided a code of commercial fair dealing that was gradually adapted to meet the changing needs of the industry; yet even as the force of religious law broke down, the system remained strong.

3. The Shift Towards a Information Technology Based Contractual Regime.

Although diamond dealing was once a predominantly Jewish profession, this is no longer true. The World Federation of Diamond Bourses has twenty member bourses, many of which are located in Asia. The industry is increasingly turning to technology to solve the problems created by ethnic diversity and geographical separation. This shift is opposed by older dealers accustomed to dealing primarily with friends and long standing business acquittances. However, as younger dealers are elected to executive positions in their bourses, changes are being proposed.

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usages. . . appraisal, justice and equity. . . and at times even upon a particular branch of a foreign legal system." Elon at 23. Jewish law, like the procedures adopted by the DDC, reflects a preference for the voluntary resolution of disputes. Jewish arbitrators were given the authority to attempt to bring about conciliation (compromise) between the parties prior to rendering their decision. Jewish arbitrators were also required to schedule hearings and render decisions promptly. Just as the DDC arbitrators are not required to produce written opinions of their decisions, "according to talmudic halakhah [Jewish law], a party may require the regulate court to submit written reasons for its judgements, but an arbitral body is not obligated to do so, even upon request." However, sometimes "it is considered desirable to make known the reason for a judgment," and this is in fact the practice in the Israeli bourse which publishes important statements of principle that are used to decide novel questions.

The similarity in the terms of the substantive law is also striking. According to Jewish law "any custom adopted by the local merchants as a mode of acquisition is valid. . . since it fulfills the principle that the purpose of the kinyan [any formal act of acquisition] is to bring about the decision of the parties to conclude the transaction. . . some authorities even regard a handshake as the equivalent of an oath." Elon at 209. In addition, under Jewish law "the decision of the parties to conclude a sale is finalized by the performance of one of the appropriate acts of kinyan ("acquisition") by one of the parties-- generally the purchaser-- that the other parties have expressed their agreement that this be done. Ownership there upon passes, regardless of the question of possession, since possession sometimes accompanies the passing of ownership and sometimes not. If the consideration for the sale is monetary payment, pay the purchase price and it becomes a debt for which he is liable." Elon at 211

Among the proposals currently being considered by the World Federation of Diamond Bourses are: setting up an international computer data base with reports of arbitration judgments from all member bourses in an attempt to foster international uniformity in trade customs, and a rule requiring that every bourse be equipped with a fax machine for rapid transmission of credit worthiness information. Also under consideration, although staunchly opposed by many dealers, is the creation of an international computer database describing goods available for sale world wide.

As the diamond industry has become less ethnically homogeneous and more geographically dispersed, the World Federation of Diamond Bourses has encouraged the creation of new bourses in an attempt to foster reputational interdependence of the individual transactors in these new markets in order to force them to monitor one another's reputation.

Although it is costly for diamantaires in new trading centers to create and maintain a bourse, the World Federation and the Central Selling Organization posses enough market power to induce these countries to set up bourses and to pay their share of the monitoring costs needed to maintain a reputation bond based contractual regime. These organizations make it clear to new entrants, who are primarily manufacturers of small stones, that their ability to secure a steady flow of rough diamonds for their cutting centers is intimately linked to their willingness to play by the established rules-- to organize bourses, set up arbitration systems, and submit claims filed against them to the Arbitration Board of the World Federation.

Intra-bourse monitoring is an effective way of insuring the continued viability of a system based on reputation and trust. A bourse's ability to attract business depends largely on the aggregate reputation of its members for trustworthiness and fair dealing. The economic viability of a bourse depends, in large part, on its ability to attract foreign dealers to its trading halls. For example, at the New York Diamond Dealers Club, 25-50% of the transactions that take place on the premises are by or on behalf of foreign entities or dealers. Diamond trade journals contain many articles about the reputation of various bourses, with particularly heavy coverage being given to new bourses. If dealers in these new trading centers want to compete in the international market, they are forced to incur the cost of setting up a bourse and monitoring the reputations of its members.

Intra-bourse reputation monitoring induced by competition between bourses is likely to be cheaper than increased monitoring by an umbrella organization such as the World Federation. Within each bourse there is a measure of social and ethnic homogeneity. Consequently, intra-bourse monitoring can take advantage of pre-existing social relationships and therefore be achieved at a lower cost than regulation by an outside body that cannot take advantage of these pre-existing relationships.

In general, the World Federation's drive to create new bourses has succeeded in combating an additional problem that has been associated with markets based on social networks among homogeneous groups, namely that "these markets may become unstable because of free riding potential, as outlying transactors may adopt the customs of the markets without bearing the costs of membership."[71] Although it may be true that in the long run "markets based upon social networks are unlikely to sustain themselves in the face of alternative markets based on sophisticated and potentially more extensive information systems,"[72] the diamond industry is currently in a state of transition; it has succeeded, at least for the time being, in creating a system that is designed to capture the benefits of both monitoring by small social groups (individual bourses) and monitoring achieved through information intermediaries (institutions such as the World Federation and brokers.)

Although trade practices and customs have remained largely unaffected by the shift from a "homogeneous group" based contractual regime towards one that is increasingly based on "information technology," the change has the potential to radically affect the economic structure of the industry. In a homogeneous group based contractual regime, it takes time to develop a reputation for trustworthiness and fair dealing since reputation information is communicated solely by word of mouth and depends largely on personal contacts. This results in high barriers to entry.[73] In contrast, information technology based regimes tend to lower barriers to entry. The introduction of new information technologies reduces the cost to an individual of informing others about his reputation and, in some instances, as

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71 Charny at 50

72 Charny at 50

73 In addition, new entrants, particularly in the manufacturing sector would also face higher capital requirements than existing market participants since their access to the implicit loan market will be limited until they establish a reputation for trustworthiness.

the market develops this cost is shifted to specialized information intermediaries.[74]

It might be argued that an outsider without an established reputation could overcome reputation-related barriers to entry by offering to transact using legally enforceable contracts. However, if extra-legal contracts are rationally preferred since they are cheaper to enforce, either because arbitration is available or because reputation bonds are working well, then a promisor who offers a written agreement would have to offer a much higher price to compensate to compensate the promisee for the risk of litigation--not only the actual cost of the litigation, but also the negative light in which being involved in a court suit would cast the breached against innocent party. More importantly, as discussed above, over a certain range of transactions values, a legally enforceable agreement is not of great value to a party.[75] Even with larger transactions, the expected value of a legally enforceable contract in the absence of information about the other party's reputation might be less than the expected value of a legally unenforceable agreement with a person with a reputation for honesty and fair dealing.[76]

e. Reputation Bonds and Economic Efficiency

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[74] For example, Dunn & Bradstreet, Standard & Poors, and in the retail jewelry business, credit ratings published by the Jewelers Board of Trade.

[75] Economic theory suggests, however, that there is some transaction value where the benefit of breach to the promisor would be so large that he would decide to break his word regardless of the effect on his reputation. In the diamond industry, the largest polished stones exchanged are usually sold at public auctions rather than at private offices, thereby greatly reducing the possibility of opportunistic breach.

[76] Although as the size of the transaction increases, the benefit of a legally enforceable contract increases relative to the transactions costs of litigation, the amount of capital that is tied up is greater, which in turn increases the opportunity cost of doing without the capital during the pendency of the litigation.

The use of reputation bonds to enforce contracts is sometimes said to be inefficient because there is no correlation between the damage suffered by the promisee and the cost of breach to the promisor. Because the cost of breach to the promisor is generally assumed to be large, reputation bonds are said to induce an inefficiently high level of contractual performance.[77] However, the most common type of executory agreement in the diamond industry is exchange of goods today for a promise to pay $X on a future date. Consequently, the most common type of breach is non-payment. On the day payment is due and the buyer has to make the the decision to perform or breach, the seller's expectancy is known with certainty; it is $X. Because breach is only efficient when the cost to the buyer of performance is greater than the value of performance to the seller, leaving aside effects due to the cost of money, performing such a contract will always be efficient since the cost of performance to the buyer does not exceed the value of performance to the seller. Thus, even a legal rule which led to no breach of contract would be efficient in the context of these transactions. This is, in fact, close to what is observed in the market; breach of contract is rare. A rule that leads to no breach of contract has additional benefits in the diamond industry where sellers routinely rely on buyer's promises to pay.

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[77] Reputation bonds are not as monolithic as critics tend to assume. A dealer does not automatically loose his entire reputation because he breaches a single contract. For example, the amount of harm to reputation from a given breach will depend on a multitude of factors such as how clear it is to others that breach occurred, whether the reason for the breach was foreseeable or a rare act of God, the extent to which the breached against party is able to communicate this information to other market participants and, in instances where the controversy is arbitrated, whether the judgment was promptly complied with.

Furthermore, in the market for polished stones, even when transactions take the form of an exchange of executory promises, there is no such thing as efficient breach. Although they are somewhat more difficult to value objectively, and cannot quite be bought and sold on a spot market, polished diamonds are much like any other commodity. Consequently, in the absence of transaction costs there is no such thing as efficient breach of contract.

Rough diamonds, in contrast, are mere inputs (along with capital, technology, and labor) into the production of polished diamonds. Consequently, an efficient market for rough stones would be one in which each rough stone found its way to its highest valued use. This would correspond to the manufacturer who was willing to pay the most for it, since as noted in Part I, a manufacture's ability to estimate the value of the polished he can make from a piece of rough is critical to his ability to earn a profit. As a matter of theory, from a market efficiency point of view, it might seem that if a seller (S) promises to sell a stone to manufacturer 1 (M1) for 100 dollars and manufacturer two comes along and offers 200 dollars, in the absence of transaction costs it makes no difference from the point of view of market efficiency if S decides to sell to M1 who then turns around a resells to M2, or if S sells directly to M2 and voluntarily pays M1 100 dollars. However, given the structure of the market for rough diamonds, if S sells to M1 it is unlikely that the stone will wind up in the hands of M2. Diamond dealers keep their trading partners secret, particularly their sources of rough, since a dealer's ability to operate at a profit depends, in large part, on his network of contacts. After buying a stone that can be cut at a profit, most manufacturers do not want to incur the search cost of ensuring that the stone can not be more profitably cut.[78] As a consequence, a rule under which sellers will always keep promises to sell particular pieces of rough diamonds to buyers, might, in practice, lead to an inefficiently high level of performance. However, given the Cartel's ability to fix the price of the rough that it sells, and the fact that it announces the magnitude of the price increases at each sight, the difference between the prices that two manufacturers are willing to pay might be small relative to the aggregate benefit of avoiding the dead weight loss of dispute resolution. An additional benefit of a high level of contractual performance in the sale of rough is that it promotes efficient reliance decisions.[79] In aggregate, the magnitude of the inefficiencies introduced through a high level of contractual performance of executory promises to deliver rough stones is likely to be small since contracts for future delivery of a stone are uncommon and possession is typically transferred at the time of contracting.[80]

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[78] This would be different if brokers were involved in the transaction since the broker would have an incentive to facilitate sale of the stone to M1, earning one commission, and then to turn around and sell the stone to M2 on M1's behalf and thereby earning a second commission. Brokers facilitate market efficiency.

[79] For example, diamond cutters are independent contractors and are generally paid by the stone. Consequently, after contracting to purchase a piece of rough a dealer will contract with a cutter. If he does not obtain the stone and does not have other work for the cutter to do, he will have to pay him anyhow. Furthermore, unlike many commercial contexts, at the time a diamond contract is made, the promisee typically is unable to estimate what his reliance expenditures will be. Reliance expenditures will depend largely on the subsequent business opportunities that present themselves to the promisee. For example, if the promisee subsequently promise to pay somebody else and is unable to do so since he, himself, has not ben paid he will therefore incurr damage to his reputation and will suffer a large loss.

[80] It is important to note that to say that the magnitude of the inefficiency introduced by an inefficiently high level of contractual performance is small, is not necessarily to say that the market for rough diamonds is characterized by only small inefficiencies. In fact, for the

Another problem associated with the use of extra-legal contracts is the cost of renegotiation, which is said to be large since the "sanction is much more likely substantially to undercompensate the promisee because implicit [extra-legal] contract bonds often do not redound to the promisee's direct benefit."[81] Although in the diamond industry the damage to the promisor's reputation does not directly redound to the benefit of the promisee, at least with respect to transactions between Club members, this problem has been solved by the creation of the Floor Committee and the Board of Arbitrators, both of which have the authority to award damages.

f. The Substantive and Procedural Advantages of Arbitration Over Adjudication

Arbitration has important substantive and procedural advantages over adjudication. Unlike the courts, DDC arbitrators can award any measure of damages they think is appropriate, including punitive damages. They can also order one or both of the parties to pay a fine to a third party beneficiary such as a charity.

As long as arbitrated judgments are promptly complied with, judgments are officially kept secret which minimizes the reputation cost of being involved in a dispute.[82] Arbitration is

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reasons mentioned in the text there are substantial impediments to rough diamonds winding up in the hands which value them the most.

[81] Charny at 35

[82] Keeping disputes secret has an economic value to dealers. If the existence of an arbitration proceeding were made public, other dealers might take it as an indication of the parties' refusal to voluntarily renegotiate agreements in the event of unforeseen circumstances. Anybody dealing with them in the future would engage in additional negotiation over contingencies which would in turn increase the cost of contracting with them.

Despite the fact that the DDC's ability to enforce its judgements depends on the market's rapid response to information about a dealer's reputation, the Club By-Laws provide that both the existence of a dispute and its resolution officially be kept secret. The reasons for this practice are unclear. However it may be that the piece of information that is most inexpensive-- filing fees are low and many disputes are resolved without the participation of lawyers. The Arbitration hearing is held soon after the filing of the complaint and judgements are rendered within 10 working days, thereby reducing problems due to the cost and unavailability of capital that can result from protracted litigation.

Furthermore, because diamond arbitrators are able to use information in arriving at their judgments that civil court judges either would not have access to or would be barred from considering by the rules of evidence, their verdicts may be more accurate. The fact that arbitrators can consider evidence that would be excluded in court is particularly important in the diamond industry since there would be problems of hearsay and authentication were these disputes to be decided in court.

Unlike judges, diamond arbitrators use their own expertise and business judgment in deciding cases. In fact, arbitrators are usually chosen largely on the basis of these attributes. In addition, those elected to the Board of Arbitrators are generally well known in the trading community and in deciding cases sometimes have independent personal knowledge of the parties' trustworthiness or business practices.

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important to the functioning of the reputation information market is not that a given individual breached a contract, but rather that he breached and did not pay the judgment rendered against him.

Furthermore, requiring arbitration judgments to be made public without introducing additional changes in the system might result in the dissemination of information that it would be difficult for the market to accurately value. If only the size of the judgment and the names of the parties were revealed, the reputation of a dealer who had an honest misunderstanding with someone in a big transaction and therefore had to pay a large fine, would be damaged more than a thief who stole a medium size stone. The facts of the case would become more important than the resolution of the dispute, and there would be a call for arbitrators to make findings of fact and to issue written opinions. This in turn would be likely to lead to a call for more procedural protections such as formal rules of evidence and the flexibility and informality of the system would begin to disintegrate.

Dealers cite the arbitrators' knowledge of industry custom as an important advantage of arbitration over adjudication. When diamond disputes do wind up in court, it is highly uncertain how much weight the judge will place on commercial custom. Both parties have an incentive to convince the judge that custom favors their argument. This leads to extensive expert testimony and creates additional uncertainty which in turn reduces the expected value to the promisee of having a legally enforceable contract.

g. The Aggregate Efficiency of the System

The importance of international transactions to diamond dealers, suggests that concluding transactions in accordance with a nearly uniform system of private law has additional efficiency benefits. If a dealer is a member of any one bourse in the World Federation of Diamond Bourses, he is automatically admitted to the trading floor of all of member bourses. Most diamond dealers frequently transact in foreign bourses. It would be wasteful for dealers to have to learn the trade rules of different bourses and to be concerned with the technicalities of concluding legally enforceable agreements in many different countries, particularly when many of those countries do not have well functioning judiciaries. The World Federation itself also has a Board of Arbitrators which has the authority to settle disputes between bourses, or to hear cases between private litigants from different bourses when there is a colorable question as to which party's bourse should hear the case. Resolving disputes through private international arbitration avoids complex questions of international jurisdiction.

h. The Importance of Reputation Bonds in the Market as a Whole

Diamond dealers consistently maintain that transactions between two Club members, between two non-members, and between a member and a non-member are conducted in exactly the same way. If the availability of the DDC's arbitration system and enforcement mechanisms were central to parties ex-ante decision making, economic theory suggests that the terms of the the transaction (either substantive or price) would be different when at least one party was a non-member. For example, a member seller who could sell a stone to another member on 30 day terms, would be expected to charge a non-member a higher price (or perhaps demand cash on the spot) to compensate for the risk of non-payment and the unavailability of arbitration. However, dealers insist that no such differences exist and that they decide who to deal with on the basis of the other party's reputation.

If reputation bonds are well functioning, this behavior is not surprising. In a transaction between a member and a non-member, the non-member has an incentive to keep his side of the bargain if he wants to be admitted to the bourse in the future. The economic benefits of bourse membership make it actively sought after by most market participants. A member can not only spread the word about the non-member's wrongdoing, but he can also object to his being accepted for Club membership. In transactions between two non-members, both parties have reason to worry about their reputations. In order to obtain a steady enough supply of rough to run an efficient manufacturing business, a non-member must a reputation as being scrupulously trustworthy. Non-members know that their future potential trading partners will inquire more deeply into their reputation before transacting with them since they do not have the Club's stamp of approval.

If dealers really did rely on arbitration to resolve most disputes, one would expect that if it was not available more disputes would go to court. This is not observed; litigation between two non-members is also infrequent. Similarly, if reputation bonds were not strong enough to enforce arbitration judgments, one would expect to see frequent recourse to the courts for judicial confirmation of arbitrated judgments. This too is not observed. Thus, it appears that the dispute resolution institutions in the diamond industry can fairly be called extra-legal: it is primarily the fear of damage to reputation that maintains discipline in the diamond trade, not the bourse's Board of Arbitrators,[83] or the procedural right to appeal arbitrated decisions.

Part IV: Arbitration and Settlement

With respect to simple disputes dealt with in the By-Laws or those dealt with according to well established custom, the decision whether to settle or go to arbitration will depend on the individual parties' estimates of the probability that they will succeed on the merits. The expected value of the arbitration to the plaintiff will be the probability of success on the merits,

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[83] Dealers differ on the importance of the availability of arbitration. Most claim that it is unimportant. However, there are indications that this may be changing. In 198? one reason dealers gave for leaving the newly formed Los Angeles Club was that it did not provide arbitration. Furthermore, the president of the World Federation of Diamond Bourses is concerned that as trust breaks downs and dealers become increasingly focused on their "rights," arbitration will come to have a more important function. He feels that the increasing importance of arbitration and third party dispute resolution requires more qualified arbitrators and greater uniformity of decisions. He believes that the bourses must meet the challenge of providing a quick and predictable way of resolving disputes or the diamond industry's independence from the legal system will slowly disintegrate.

times the projected recovery, less the cost of legal representation if he is represented by counsel, less, depending on the arbitrator's whim, the cost of arbitration if he is made to bear it. The By-Laws provide that the plaintiff must pay the arbitration fee in the first instance, but give the arbitrators the discretion to refund the fee or order the defendant to pay it. Although this fee shifting term is a wild card, it is bounded by the actual cost of arbitration which is quite low relative to the amounts at stake in the arbitration.[84] Conversely, the expected cost of the arbitration to the defendant is the probability of losing times the damage award, plus legal fees if he is represented by counsel, and, perhaps, the cost of the arbitration if the arbitrators, in their discretion order him to pay it. Models of suit and settlement[85] suggest that the closer the plaintiff and defendant's estimates are of the expected outcome of the litigation, the more likely they are to settle. Consequently, to the extent that the required pre-arbitration conciliation proceedings shed light on the strengths and weaknesses of the parties' arguments, they would be expected to lead to a high rate of settlement. This is what is observed; 80-85% of the disputes that are submitted to arbitration are settled during the mandatory conciliation phase of the proceedings.

In more complex cases, such as labor disputes, trademark infringements, partnership disagreements, and the use of new techniques to make flaws in stones invisible to the human eye, where a party cannot simply be ordered to pay the money owed or to

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84 See note 31 supra at page 16.

85 See e.g., S. Shavell," Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs," J. Legal Stud. (1982)

deliver or return the stone in question, the arbitration panel either hears the case, or, if the case falls into one of the four categories enumerated in the By-laws,[86] the parties are left free to seek a resolution of their dispute in court. However, when arbitrators opt to decide complex or novel cases, it is difficult for the parties to predict the rule of decision and/or the damage measure that arbitrators will apply. Arbitrators neither make findings of fact nor render written opinions announcing their decisions, past decisions are therefore a poor predictor of future outcomes.[87]

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[86] See text supra at 18

[87] In general, one of the main problems with arbitration as a method of commercial dispute resolution is its unpredictability. This is due, in part, to the lack of both written decisions and a tradition of stare-decisis. In complex situations, a promisor has to be able to calculate the cost of breach if he is to be induced to make efficient breach decisions. When he is unable to make at least reasonably accurate predictions, breach of contract becomes a gamble and arbitration a process of conferring windfall gains and losses on the parties. The complete secrecy of all aspects of arbitrated judgements is not the norm in the Israeli bourse. In Israel, the arbitrators publish written announcements of the principles used to decide novel cases (the parties, however, are not revealed). Many other bourses in the World Federation have a similar practice. The WFDB recently proposed compiling a computer data base of these statements of principle in order to promote world wide uniformity of arbitrated judgements, and to prevent "forum shopping." They have also proposed additional uniform training programs for all arbitrators.

Some members of the DDC board of arbitrators are concerned that the lack of published opinions explaining the basis of decisions gives dealers the wrong signals about what type of behavior is sanctioned. Although cases are officially kept secret, the industry is "like a bunch of old ladies," and in new and unusual cases the result can rapidly become known. A few years ago a case arose which revived the debate over the secrecy of judgements. The Yehuda treatment is a way of altering a stone such that its flaws become invisible to the human eye unaided by special technology. The firm which developed this process and actually treats the stones, requires those they deal with to sign an agreement requiring them to disclose the stone's treatment to any potential buyers. Soon after the treatment was introduced, but before it was widely known, a dealer sold a treated stone without disclosing the treatment. The buyer subsequently discovered the treatment and filed a claim against the seller. The seller defended on the grounds that he did not know or have reason to believe that the stone had been treated. The Board of Arbitrators ordered recission of the deal and imposed a very small fine on the seller. One arbitrator wanted to write an opinion explaining that the only reason the judgment was so small was that the treatment was new so that a dealer in exercise of ordinary care would not have been expected to ask whether or not the stone had undergone this treatment. However, by the time the arbitration was concluded, the treatment had become so well known

As a consequence of both parties' inability to predict how the arbitrators will decide complex cases, in situations where the parties do not differ greatly in their degree of risk aversion and have similar estimates of the degree of uncertainty in the arbitrators decisions, they will also have an incentive to settle, just as they did when they had near perfect information about the rule of decision and the damage measures that the arbitrators would employ were certain. [88]

Part V: The Effect of Legal Intervention into the Extra-Legal Contractual Regime

In general, diamond dealers prefer to conclude agreements using extra-legal contracts. However, certain types of agreements made in the course of diamond transactions are routinely subject to interpretation by the courts since they often involve the rights of third parties. Consequently, these agreements often take the form of legally enforceable contracts.

First, when a bank or an insurance company is a direct party to an agreement, legally enforceable contracts are often used. Unlike individual buyers and sellers, banks and insurance companies do not have an interest in the maintenance of the secrecy norm. These institutional actors often have significant bargaining power, particularly the banks since in most countries a relatively small number of banks provide most of the industry's

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that a similar defense of ordinary care would not prevail in the future and the arbitrators intended to impose extremely heavy fines in subsequent cases.

[88] A similar phenomenon is observed in bankruptcy proceedings conducted under Chapter 11. When a class is impaired, the plan must be confirmed under §1129(b) and the court must determine whether it is fair and equitable to the impaired class. Because this requires the court to engage in difficult and uncertain valuation calculations, this section gives the debtor an incentive to make as many classes as possible unimpaired under §1124 of the chapter. The uncertainty inherent in the valuation process creates an incentive to settle.

financing. Consequently, banks are often able to obtain the benefit of having both a legally enforceable contract--such as a standard loan agreement-- as well as a reputation bond.[89] One reason a relatively small number of banks are involved in the diamond industry is that evaluating the worth of a stone (often used as inventory collateral) in the absence of an objective and readily ascertainable "market price," requires an expertise in gemstones that bankers seldom have. Consequently, many loan decisions are really made on the basis of the bank's perception of the dealer's reputation in the marketplace. As an officer of the Merchants Bank of New York which is located in the middle of 47th street explained, "In terms of extending credit a bank has to look at the 3 C's-- Capital, Culpability, and Character. At our bank, we think that character is the most important C."[90] Thus, although defaulting on a loan would hurt any businessman's credit rating, the damage to a diamond dealer is more severe since there are only a few industry lenders and banks must rely to a greater extent on the dealers' reputation in valuing his assets.

Second, in transactions where banks or insurance companies are not directly involved -- such as a situation where a dealer gives a broker or another dealer goods to sell on consignment-- but where their rights may later be affected and the law invoked for protection, dealers have, especially in large scale transactions, turned to legally enforceable contracts.[91] When a

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89 In this context the reputation bond functions as implicit collateral.

90 Merchants Bank Moved and Grew with Industry." New York Diamonds (Dec. 1988, No. 3) p. 38

91 There are additional reasons for this. In the diamond industry the norm of honesty is an intra-industry norm, it does not apply with full force to banks, insurance companies and the government. Thus banks and insurance companies are unable to fully reap the benefits of intra-industry reputation

dealer gives goods on consignment, a formal consignment memorandum that satisfies the requirements of the Uniform Commercial Code is sometimes drawn up. Dealers explain that these documents are designed to serve two distinct purposes. As between the dealers, their function is similar to that of the bill of sale, weight slip, or cachet wrapper--they are intended to help the dealers privately settle any disputes that may arise by clarifying the terms of the original agreement. These agreements are not drawn up in the form of legally enforceable contracts because the dealers think the consignee will run off to the Bahamas with the goods. The same risk of loss would be present in any sale for future payment (especially since consignment agreements and sales are often made between the same people), a situation in which dealers clearly prefer extra-legal agreements. In consignments, legally enforceable contracts are sometimes used because these transactions are often interpreted in the course of legal proceedings since they frequently involve the rights of third parties.[92] In this context, courts are reluctant to credit arguments based on trade custom or usage; decisions often ignore the intent of the parties and redistribute rights in ways that are less then optimal.

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bonds. One medium sized bank has, however, attempted to obtain the benefit of these bonds. <u>See</u> Note 44 supra at 25.

[92] For example, when a stone on consignment is lost or stolen and an insurance claim is filed, it is unclear whose insurance carrier, the formal owner or the consignee's, has an obligation to pay. Similar problems arise in bankruptcy proceedings since "diamonds delivered on memo to a broker or dealer usually cannot be recouped from a trustee in bankruptcy, an assignee for the benefit of creditors or even from a bank from whom your consignee has borrowed money and given his bank the normal and usual security interest in his inventory and accounts." S. Herman Klarsfeld, "Legal Gems," New York Diamonds (May 1988, No. 1) p. 40. In contrast, under the trade rules, the consignor retains title to the goods until they are sold.

Consignment agreements used to be concluded orally. Under the trade rules for consignment, title to the goods remained in the owner and he was entitled to get them back if they were not sold on his behalf. However, the courts generally refused to recognize the existence of the extra-legal contract to return the goods, finding them to be the property of the consignee. When the rights of banks or insurance companies are likely to be involved, diamond dealers fear legal intervention into the regime of extra-legal contract -- whether through enforcement or abrogation of extra-legal contracts-- and opt for legally enforceable explicit contractual agreements. As the Club's legal counsel recently advised dealers "the Uniform Commercial Code (UCC) will give you protection if you adequately describe your diamonds and file a UCC-1 Financing Statement with the Secretary of State in Albany and with the register of the county in which the consignee has an office. . . This will give you a legal leg to stand on if you unfortunately have to seek the return of your merchandise from a bank or a trustee in bankruptcy." [93]

One of the main costs associated with legal intervention into extra-legal contractual regimes, is that "[i]t inhibits parties from making various forms of informal commitment for fear of resulting legal liability, and more generally may prevent communicating information to transactors, and developing reputation."[94] These effects can be observed in the diamond industry where fear of legal intervention has made the Club increasingly reluctant to suspend or expel members who do not

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[93] New York Diamonds. (May 1988, No. 1) p. 63.

[94] Charny at 75

comply with arbitration judgments, one of the primary ways the Club can enforce its decisions and communicate information about individual dealer's reputations to the market place.

Throughout its history, the diamond business has been largely self regulating, operating outside the law of the state. Over the past thirty five years, the private dispute resolution mechanisms in the New York market, combined with widespread adherence to the secrecy norm, have succeeded in maintaining a largely extra-legal contractual regime where transactions are concluded on the basis of the dealers' reputations and the incidence of breach is low.

However, over the past decade a subtle change has been taking place--the legal system has begin to interfere with both the substantive rules used to decide arbitrated cases, as well as the ways in which these decisions are enforced. Under the DDC By-laws, the Board of Arbitrators has the power to suspend or expel a member if he does not comply with a judgment. However, ever since Martin Rapaport decided to break the secrecy norm by initiating the first suit against the Club as the Club for any reason other than disagreement with an arbitration decision, there has been a profound change in the way the Club decides cases and enforces judgments. The case has made the Club much more reluctant to expel members --it is concerned not only about the expelled member bringing suit, but also fears that too many expulsions will revive the FTC's interest in its activities. At present a member is not expelled until the Board of Arbitrators first obtains a court order affirming its decision. However, effective sanctions may still remain since the member's picture, along with a description of the judgment that he refused to pay will still be hung in the Club Room and on the trading floor of every bourse in the World Federation of Diamond Bourses.

Although the DDC By-Laws have always given the litigants the right to be represented by a lawyer, [95] prior to the Rapaport case it was uncommon for the parties to be represented by lawyers. Today, in contrast, legal representation is the norm. The arbitrators feel that the presence of lawyers has, in some measure, altered the rules of decision they apply. The lawyers alert them to relevant parts of New York law and while this law still does not supply the rule of decision, the arbitrators are more conscious of the law and are increasingly reluctant to drastically depart from it, except in instances where the decisions are deeply rooted in custom or do not involve creating a new rule. Although the Board of Arbitrators has traditionally declined jurisdiction in cases involving complex statutory rights or claims that are intertwined with pending litigation, in recent years this has become a more common practice. The older arbitrators fear that legal interference in the diamond trade will one day destroy the traditional way of doing business.

Part VI: Conclusion

As Parts III and IV demonstrated, from the perspective of those already engaged in the diamond trade, their mutual interest is, for a variety of reasons, better served by their system of private law than by the legal system. The legal system is not well suited to resolve the types of disputes that arise: the cost and delay of litigation, the difficulty the courts would have in determining whether or not breach occurred, and the fact that even

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[95] This is required of any arbitration system whose decisions are given binding effect under New York law.

expectation damages do not fully compensate the promisee, suggest that were diamantaires to rely on the law of the state, the market would be characterized by inefficiently high levels of breach of contract. Market transactors would also have to bear large deadweight losses due to the cost of resolving disputes.

Although these factors affect most commercial contracts that rely solely on legal enforcement to induce performance,[96] legally enforceable contracts may be, in practice, the best alternative available to transactors in most markets. In contrast, in the diamond industry, contracting out of the legal system is possible because the industry is able to make and, more importantly, enforce its own rules. The market is organized to promote the low cost and rapid intra-industry dissemination of information about reputation which enables it to use reputation bonds to create an effective deterrent to and punishment for breach of contract.

The customs and institutions in the diamond industry emerged for reasons wholly unrelated to shortcomings in the legal system; yet even as the force of the old enforcement mechanisms of religion and secondary social bonds began to disintegrate, a network of trading Clubs which are designed to promote the dissemination of information about reputation and socialization among members emerged to fill the gap. The fact that generations of diamond dealers have clung to these traditions in countries with such a wide variety of legal rules and institutions, suggests that the traditional rules and institution are likely to be efficient from the perspective of market insiders. In the United States these customs and institutions have endured, over time,

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[96] Complex commercial contracts typically include provisions designed to induce performance independent of recourse to the legal system.

and demonstrated their superiority to the established legal regime.

Although it has been argued[97] that the availability of legal enforcement of arbitrated decisions means that the diamond industry's system of law is not really an extra-legal/cooperative norm based regime, several observations suggest that the system can fairly be called "extra-legal." First, if market transactors preferred to opt into the legal system, the cost of using a legally enforceable written form contract would be small. Consequently, since form contracts are not used it is reasonable to assume that individual market participants believe that they would be worse off were they to use such a contract. Second, in those situations where market participants think that they can better protect their interests through recourse to the legal system, or that the legal system is likely to intervene to protect the interests of third parties, explicit written contracts are used. Furthermore, it is rarely necessary for the prevailing party in a DDC arbitration to have to seek legal enforcement of his judgment; it is the industry's ability to quickly turn breach of contract into damage to reputation that disciplines dealers and enables transactions to continue to be concluded on the basis of word of mouth and trust.

In the diamond industry "trust" and "reputation" have an actual market value. As an elderly Israeli diamond dealer explained, "when I first entered the business, the conception was that truth and trust were simply <u>the</u> way to do business, and nobody decent would consider doing it differently. Although many

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[97] Conversation with Professor Frank Upham of the Boston College School of Law (October, 1989)

transactions are still consummated on the basis of trust and truthfulness, this is done because these qualities are viewed as good for business, a way to make a profit."