OPTING OUT OF THE LEGAL SYSTEM: EXTRALEGAL CONTRACTUAL RELATIONS IN THE DIAMOND INDUSTRY

*LISA BERNSTEIN**

I. Introduction

Business disputes arise in all industries, and the diamond industry is no exception. Unlike the situation in many other industries, however, diamond industry disputes are resolved not through the courts and not by the application of legal rules announced and enforced by the state. The diamond industry has systematically rejected state-created law. In its place, the sophisticated traders who dominate the industry have developed an elaborate, internal set of rules, complete with distinctive institutions and sanctions, to handle disputes among industry members. This article explores the reasons that this system of private governance has developed and endured within the diamond trade.

Section II provides a brief overview of the diamond industry. It sketches the workings of the international diamond cartel and discusses diamond production and valuation. Section III 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 that keeps all judgments secret as long as they are promptly paid.

Section IV is the core of this article. Section IV*A* briefly considers why diamond dealers need to make executory contracts; it then explains that the diamond market also operates as an implicit loan market. Section IV*B* compares the cost of entering into legally unenforceable (extralegal) agreements to the cost of entering into legally enforceable contracts. It

* Associate Professor, Boston University School of Law. I would like to thank Steven Shavell, Louis Kaplow, Lucian Bebchuk, and David Charny. The John M. Olin Foundation provided funding for this project.

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concludes that the transaction costs of entering into legally enforceable agreements cannot explain diamantaires' preference for extralegal agreements and suggests that the norm of "secrecy" that pervades the industry is at least a partial explanation for diamond dealers' preference for privately enforced agreements.

Section IV*C* considers the characteristics of public law that make contracts enforced through litigation an unattractive option. Its 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 way courts calculate damages, the time it takes to obtain a judgment, and 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, the diamond industry is unique in its ability to create and, more important, to enforce its own system of private law. Sections IV*D* and *E* focus on the ways the industry's organization facilitates the creation of strong reputational bonds, which the bourse's arbitration system in turn uses to enforce its judgments. They examine two types of reputation-bond-based extralegal contractual regimes: the homogeneous group regime that is generally associated with repeat transactions among members of small geographically concentrated and ethnically homogeneous groups, and the information-intermediary regime in which technology links markets and secures the rapid and low-cost dissemination of information about reputation. Although 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 an overarching system that captures the advantages of both regimes.

Section IV*F* explores some of the efficiency implications of reputation bonds, relative to those created by court-imposed expectation damages. Section IV*G* discusses the substantive and procedural reasons why arbitration is preferred to litigation. Finally, Sections IV*H* and *I* assess the aggregate efficiency of the system and the importance of reputation bonds in the market as a whole. In sum, the analysis presented in Section IV suggests that, while the damage rules adopted by the industry may lead to some instances of inefficient breach, the system's overall success is due, in large part, to its ability to quickly resolve disputes and enforce judgments—results that cannot be obtained through the legal system.

Section V uses a model of arbitration and settlement to explain why most intraindustry disputes are resolved cooperatively and without recourse to a third-party arbiter. Section VI considers the changes in the industry that have led 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 diamond transactions and the resolution of disputes. Section VII concludes that the diamond industry provides strong support for the hypothesis that extralegal norms trump legal rules in a given market only where market participants find that keeping to the industry norms advances their own self-interest. The private regime must be Pareto superior to the established legal regime in order to survive.[1]

II. 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.[2] Rough diamonds are found primarily in Africa, Australia, and the Soviet Union; they are not notably rare. At present, 80–85 percent 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. The brokers then sell presorted boxes of diamonds to some 150–200 dealers, known as sight holders,[3] during ten viewing sessions, or sights, held in London each year. Most U.S. sight holders are members of the New York Diamond Dealers Club (DDC). At a sight, a dealer is given a box of diamonds and informed of its price. This price is nonnegotiable. If the dealer decides not to purchase his box, he will not be invited to subsequent sights. Consequently, a sight holder will rarely decline to purchase his box,

[1] A similar thesis is advanced by Robert C. Ellickson, A Hypothesis of Wealth Maximizing Norms: Evidence from the Whaling Industry, 5 J. L. Econ. & Org. 83, 84 (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." For a broader and more theoretical articulation of this thesis, see generally, John Gray, Hayek on Liberty (2d ed. 1986), discussing Hayek's theory of spontaneous order and the "competitive selection of rules and practices," particularly, "Hayek's assertion that the evolution of culture may itself be fruitfully investigated in terms of the competition between different traditions or practices, with a natural selection among them occurring which is at least partly to be explained by their relative efficiency as bearers or embodiments of knowledge."

[2] The markup from mine to consumer is estimated to be between 200 and 400 percent.

[3] There are three kinds of sight holders: large manufacturers who cut and polish the stones themselves, midsize rough dealers who resell the contents of their boxes to select manufacturers, and brokers who deal in industrial diamonds. Polished stones are sold to wholesalers and marketed through brokers, both of whom then sell to retail establishments.

although he will sometimes negotiate in advance to sell it unopened to another dealer on a cost-plus-profit basis.

The cartel insists that the diamonds be paid for in full within seven days of the sight. Consequently, for most sight holders, particularly those who cut and polish the rough themselves, access to credit is essential—it takes three–four months from the sight date for a manufacturer to sort, cut, polish, and sell the contents of his box. Sight holders, however, rarely have difficulty securing financing. In the diamond industry, having a sight is considered a near guarantee of financial success. The cartel actively monitors the decisions and activities of sight holders; if a sight holder 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, sight holders 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. Since 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, that difference, on which profitability turns, often reflects a real difference in the value of the polished stones they will be able to cut from it.

In contrast, when dealers value a polished stone differently, most of that difference will be due to their differing estimates of market demand and to their differential skill in detecting flaws in stones. In recent years, however, the skill factor has become less important. Although older dealers continue to maintain that even polished diamonds cannot be objectively graded and valued, in the late 1970s, the Gemological Institute of America began to issue diamond grading certificates whose widespread use made it possible for dealers with little gem expertise to enter the market, resulting in increased competition. By creating standardized ways of describing polished stones, grading certificates have facilitated the flow of price information. A private diamantaire now publishes a weekly price list with a wide international circulation.[4]

As a consequence of the standardization of grading and the availability of price lists, the market for polished diamonds has become more com-

[4] Unlike a closing quotation on a typical commodities exchange, the prices recorded in the *Rapaport Diamond Report* are not actual transaction prices. Rather, they are the Rapaport Corporation's subjective calculation of the "high asking" price, generally 15–30 percent above the actual transaction price, for various sizes and grades of polished stones. One explanation for the markup is that it enables retailers to quote list prices to consumers who think they are getting a bargain when they buy below it.

petitive and prices have dropped. This has reduced the profit margin of manufacturers since retailers now have more reliable information about what wholesalers and manufacturers have paid for stones. Manufacturers find themselves squeezed between the price of rough fixed by the cartel and the competitive prices in the polished market.

III. 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. Its membership is comprised of sight holders, manufacturers, wholesalers, and brokers. 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 worldwide diamond distribution network—will be at a competitive disadvantage. Approximately 80 percent of the rough diamonds coming into the United States pass through the hands of a DDC member, as do 15–20 percent of the polished stones. In addition, 20–50 percent of the transactions conducted by or on behalf of foreign or out of town dealers are concluded in the club.[5]

The New York DDC currently has 2,000 members; in most years 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.[6] As a condition of mem-

[5] Despite the strict limits on the number of members it accepts, the DDC tries to attract out-of-town dealers (and nonmembers) 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.'' Diamond Dealers Club Bylaws (hereinafter DDC Bylaws), Art. 17 § 2a (1980). Consequently, nonmembers 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 bylaws, 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 percent on every transaction the out-of-town dealer consummates.

[6] To be considered for membership a dealer must (1) have been in the industry for at 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 ten days so that members have the opportunity to state reasons that he should not be accepted. New members are put on

bership, a 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.[7] 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 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 light. Furthermore, for security reasons, many dealers do not want it 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 is available for certain classes of polished stones, the bourse's trading floor 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.[8]

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 with additional informational benefits. In general, the reputations of smaller dealers are less well established. Club membership en-

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probation for a period of two years during which "the Board of Directors reserves the right to terminate such membership at any time within this period for any reason." *Id.* at Art. 3 § 8. New members are charged a $5,000 initiation fee, and annual dues are $1,000.

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. See Diamond Dealers Club Arbitration Bylaws (hereinafter DDC Arbitration Bylaws), Art. 12 § 25 (1987). The corporation or partnership is also considered liable and bound by the members' agreement to submit all disputes to the DDC arbitration system. DDC Bylaws, Art. 3 § 2b.

The traditional view of diamond trading as a family business is reflected in the membership bylaws: more lenient rules govern the admission of sons, daughters, sons-in-law, and daughters-in-law. For example, *id.* at Art. 3 § 2a, provides that 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*." *Id.* at Art. 3 § 3b.

[7] See *id.* at Art. 12 § 1c.

[8] The Federal Trade Commission estimates that 700–800 dealers use the club each day.

ables them to signal 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.

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."[9] The bourse facilitates the transmission of information about dealers' reputations[10] and, at least with respect to members, serves both a reputation-signaling and a reputation-monitoring function.[11]

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.[12] A dealer who is a member of any one bourse in the world federation is automatically allowed to trade at all member bourses. Each bourse has 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 federation, each bourse is required to enforce the arbitration judgments of other member bourses to the extent permitted by the law of the country in which it operates.[13]

B. *The Standard Transactional Paradigm*

In the diamond industry, a handshake accompanied by the words *mazel u'broche* creates a binding agreement. Section One of the Trade Rules

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

[10] 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 Forty-seventh Street itself.

[11] As stated in its bylaws, the purposes of the club 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 Bylaws, Art. 2.

[12] The DeBeers Cartel does not control the WFDB. One of the main reasons the WFDB was formed was to enable the bourses to bargain more effectively with the cartel. See, generally, Albert Lubin, Diamond Dealers Club: A Fifty Year History (1982).

[13] For more information on the rules of the World Federation, see World Federation of Diamond Bourses: Bye-Laws and Inner Rules (unpublished report, World Federation of Diamond Bourses, November 15, 1988).

provides: "[a]ny 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."[14] While older dealers continue to adhere to this tradition in a steadfast manner, younger dealers who tend to be less well acquainted with their trading partners and more worried about the prospect of misunderstanding or breach often memorialize the key terms in writing, despite the fact that such a writing is not required for formation of a binding agreement.

The most common transactional paradigm is known as "open cachet."[15] 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 on the offerer until one o'clock the next day. The seller may accept at any time during this period by contacting the buyer and saying "mazel and broche." If, however, the seller either rejects the offer or makes a counteroffer during this period, his option to accept the buyer's original offer is canceled.

There are sound 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."[16] 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. A buyer's reachability is difficult and costly to monitor given the variety of plausible excuses that could be invented. Thus, a more explicit form of contract is used to overcome the weakness of the reputation bond. Finally, in open cachet transactions

[14] DDC Bylaws, Art. 18 § 1.

[15] Another type of cachet used less frequently than open cachet is known as a "Zee'ch," or "search" cachet. 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 twenty-four 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. 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.

[16] DDC Bylaws, Art. 18 § 3.

there is generally no such thing as opportunistic breach by a 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 seal to discourage this and make its violation known to the buyer. Nonetheless, if the seller receives a higher offer on the stone from someone who viewed it prior to consummation of the cachet, the trade rules permit him to terminate the cachet by contacting the original cachet holder. It is customary, however, for him to tell the original buyer of the new offer and to give him the opportunity to match it. This leads to a miniauction with the stone being sold to the highest bidder.

Although the cachet is formally 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 five hundred dollars per karat for the stone, the broker might tell the seller that the buyer offered four hundred dollars per karat. If the seller accepted, the broker would pocket 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.

When a deal is physically concluded on the floor of the DDC, a document akin to an integrated writing is frequently, but not always, produced. After the parties have either made an oral agreement or gone through the formalities of cachet—that is, at a stage in the transaction where the parties already consider themselves bound—they take the goods to be weighed by a club employee who issues them an official weight slip. 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. 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. Only one copy 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.

In some instances, stones are traded not on the floor of the DDC but in private offices. In this case, a standard bill of sale is drawn up when the deal is concluded and before the buyer leaves with the stones. Frequently, however, it is 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.

Even if either the weight slip or the bill of sale satisfied the requirements of the New York Statute of Frauds, a suit could not be brought in either New York State Court or federal court 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, an estimated 85 percent are settled during the mandatory prearbitration 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 and not to a deterioration of trade ethics.

The DDC's procedural rules clearly reflect the industry's preference for the voluntary resolution of disputes. The bylaws are structured to give the parties control over the dispute resolution process and to create financial incentives to settle. For example, prior to an arbitration hearing, the parties are required to participate in a conciliation proceeding, and "whenever an adjustment by conciliation is consummated, the chairman of [the three-person conciliation] panel may refund the arbitration fee or any part of the same."[17]

An important feature of the arbitration system is the secrecy of the proceedings. 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 with, the fact of the arbitration as well as its outcome are officially kept secret.

Procedural Aspects of Arbitration. There are two dispute resolution bodies in the DDC, the Floor Committee and the Board of Arbitrators; both are composed of club members elected for two-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 familiar standard for granting summary judgment.

The Floor Committee has the authority to exclude a member from the trading hall for up to twenty 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."[18] A decision of the Floor Committee may be

[17] DDC Arbitration Bylaws, Art. 12 § 8.

[18] *Id.* at Art. 8 § 7B1.

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.

Any member of the DDC who has a claim "arising out of or related to the diamond business"[19] against another member has 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 a small arbitration fee,[20] 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."[21] Arbitrators are required to render their decision within ten days of the hearing.

Arbitration awards can be appealed if notice of appeal is filed with the board of directors within ten days of the parties' receipt of the judgment. The appellant must pay a fee three times the original arbitration fee and "deposit cash or sufficient security to cover the amount of the judgment."[22] 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."[23]

The decisions of the arbitration board can be appealed to New York State court under New York law, but arbitration awards can only 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.[24] The substantive rule of decision is not reviewed.

[19] *Id.* at Art. 12 § 1a.

[20] *Id.* at Art. 12 § 2.

[21] *Id.*

[22] *Id.* at Art. 12 § 15.

[23] *Id.* at Art. 12 § 17.

[24] See, for example, 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 Bylaws do authorize arbitrators 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, for example, Rabinowitz v. Olewski, 100 A.D.2d 539; 473 N.Y.2d 232 (2d 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 accusing 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").

Although the DDC arbitration system is operated primarily for the benefit of club members, nonmembers 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 nonmembers might request that the DDC arbitrate a dispute with a member. First, if the nonmember knows he is in the wrong, yet the parties are unable to agree on a settlement, then having a neutral third party assess a penalty should enable him to minimize the reputation cost of his breach since arbitration awards are kept secret if the judgment is paid promptly. Although the arbitration's results 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. Second, if the nonmember thinks he is in the right, arbitration is preferable to litigation because it is cheaper, faster, and subjects the member to unqiue pressures to pay promptly. Although club members are not obligated to submit disputes with nonmembers to arbitration, they will often agree to do so in order to avoid the transaction and reputation costs of going to court.

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 these are set forth with particularity in the club's bylaws, and others simply are 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 that have explicit remedies prescribed in the trade rules;[25] those that have no explicit remedies prescribed but are common enough that they are dealt with consistently according to widely known customs; and those complex disputes that 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 bylaws, 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 nonconveniens' in that it is burdensome or inconvenient to handle the claim in the Club; (3) involves nonmembers; (4) has been

[25] See DDC Bylaws, Trade Rules II: Customs and Usage. For the rules governing transactions in certificate stones, see DDC Arbitration Bylaws, Trade Rules Regarding Certificate Stones.

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.''[26] 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 common sense, some Jewish law, and, last, common-law legal principles. 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; they 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 thirty to forty go to judgment. 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 the arbitrators were biased, unfair, or relied on evidence that lacked probative value. The arbitration board is like a jury black box. Diamond dealers eschew arbitration for many of the same reasons that businessmen in general are wary of jury trials, primarily the uncertainty of the outcome.

A person who is found to have breached an agreement or engaged in unethical conduct is sometimes ordered to pay punitive damages or a fine in the form of a donation to charity in addition to compensating the other party for his loss. Thus, unlike court awards that, 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. As the incident had become widely known throughout the club, however, 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 a fifty thousand dollar donation to a Jewish charity.

[26] *Id.* at 12 § 1b. See, for example, Finker v. The Diamond Registry, 469 F. Supp. 674 (S.D.N.Y. 1979) (where the DDC agreed to decide issues concerning the ownership of goods held on memorandum (consignment) but ''refused to involve itself in the dispute concerning the trademark registration and alleged infringement'').

Enforcing Arbitration Judgments. The DDC Bylaws provide that "[a]ll 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."[27] 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 failing to pay a judgment or failing to pay his diamond-related creditors without making special arrangements through the club's private bankruptcy system.[28] 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: "[a]ny settlements made outside of the jurisdiction of the Club do not absolve the debtor member's liability for suspension purposes."[29] 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";[30] 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,"[31] and a creditors committee is formed to effect the distribution. While bankruptcy proceedings are taking place, the debtor is not allowed to enter the club room unless given explicit permission to do so by the club committee.[32] Similarly, "where the debtor has requested a settlement with his creditors for any sum less than one hundred percent (100%), and has not complied

[27] DDC Arbitration Bylaws, Art. 12 § 26.

[28] See, generally, DDC Bylaws, Art. 20.

[29] *Id.*, Art. 20 § 18. In addition, a member is automatically suspended from the club for "filing a petition in bankruptcy or any involuntary petition in bankruptcy, [or] making an assignment for the benefit of creditors." DDC Arbitration Bylaws, Art. 7 § 1.

[30] DDC Bylaws, Art. 20 § 18.

[31] *Id.* at Art. 20 § 2a.

[32] See, for example, 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").

with the action required of him as set forth in this article,''[33] he may be suspended or expelled from the club and his name is circulated to all of the bourses 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 bona fide debtor and has made provisions for the payment of one hundred percent (100%) of his/her debt.''[34] Formerly bankrupt members who comply with the club's bankruptcy rules are sometimes readmitted under this provision.

In general, the Board of Arbitrators uses suspension more frequently than expulsion to secure compliance with its decisions. Expulsion presents a classic end-game problem. The expelled member may feel like he has nothing to loose by challening the club—he can try to upset the board's decision in court, file a private antitrust suit, or sue in tort for interference with business relations. The bylaws, however, provide that a member who was suspended or expelled may be readmitted after two years on the same terms as a new member. Although this provision appears to be a partial solution to the end-game problem, due to the long waiting list of those already qualified for club membership and the subjectivity of the admissions process, dealers are not routinely readmitted under this provision. Furthermore, even if the admissions committee voted to readmit a dealer, his ability to avoid being shunned would depend on the original reason for his expulsion. The bylaw provision was probably included to enable the club to avoid charges of intentional interference with business relations.[35]

Under New York law, binding arbitration awards can be confirmed in civil court. If this is done, the judgment has the same force and effect as an initial court award. In practice, however, it is rarely necessary for a party to a DDC arbitration to seek confirmation of a judgment. While arbitration awards are officially kept secret, a confirmation proceeding in court would quickly become public knowledge. Thus, 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

[33] DDC Bylaws, Art. 20 § 11a.

[34] *Id.* at Art. 20 § 19.

[35] 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 World II, an article was added to the bylaws that cautions members not to engage in any behavior that can be construed as being in restraint of trade.

who prevailed finds it necessary to obtain a court enforcement order, the DDC bylaws require the losing party to pay an additional 15 percent of the award to cover his opponent's legal expenses. Another enforcement mechanism sometimes invoked by the arbitrators is 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 is a powerful threat against Orthodox members of the diamond industry.

IV. An Economic Analysis of the Extralegal Contractual Regime

A. *The Reasons That Executory Agreements Are Needed*

In order to understand contractual relations in the diamond industry, 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 important, 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, it is neither possible nor beneficial in many instances. There is a great need for credit in the diamond industry. As explained above, even the largest sight holders need credit to finance the purchase of their boxes of rough. Similarly, non-sight holders also acquire most of their stones on a cycle that follows, but lags behind, the schedule of sights. They 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 percent occurring in November and December, access to credit is needed to avoid a cash shortfall.

After the diamond crash of the early 1980s,[36] banks became more reluc-

[36] As a result of a confluence of factors, the diamond industry suffered a severe crash in the late 1980s. Throughout the mid- to late 1970s, the Israeli banks began extending low interest rate loans to rough dealers at the direction of the Israeli government, who wanted to expand the diamond cutting industry in Tel Aviv. The only collateral required was the

tant to finance diamond dealers, particularly small dealers and non–sight holder manufacturers. As a consequence, bargaining over the term of payment became an important and contentious stage in contract negotiation. The most common terms are immediate cash payment, thirty-day terms, and sixty-day terms. The thirty- and sixty-day periods correspond roughly to the time it takes to manufacture a stone. This varies depending on the cut, the stone, and the skill of the manufacturer. 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.[37] One possible explanation for the extension of credit by sellers is that sellers typically have better and less expensive access to outside capital than most buyers. Many of the important sellers are also DeBeers sight holders. The fact that a dealer is a sight holder sends a signal to the bank that he is a good credit risk. Banks prefer to lend to sight holders because they need not incur the large cost of valuing gems that they would have to bear if they lent to non–sight holders whose inventories are in a constant state of flux. Lenders can offer lower interest rates to sight holders because they can have greater confidence when they make loans and most monitoring costs are shifted to the cartel. Unlike banks, sight holders are industry insiders; they have good information about individual dealers' reputations and transact with the same people on a repeat basis over a long period of time. It is thus cheaper for sight holders to monitor dealers' reputations and credit worthiness than it is for banks. Consequently, it is likely that sight holders can offer terms

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diamonds actually purchased, which were stored in the banks' vaults. When the world economy entered a recession in 1980, dealers found it difficult to resell their diamonds and, as the price began to fall, they defaulted on loans. The banks found themselves with a 1.5 billion dollar stockpile of diamonds, more than the DeBeer's Cartel could afford to repurchase to maintain the price. Although an agreement between the cartel, the Israeli government, and the Israeli banks was finally reached that prevented the entire stockpile from being immediately released into the market, enough were resold to drastically lower prices.

At around the same time the "investment diamonds" scheme that had been developed in the late 1970s, whereby telephone salesmen sold sealed packages of "investment" grade diamonds to investors along with a promise to repurchase them at a later date, also went bust when the companies failed and purchasers tried to cut their losses by selling the diamonds on the open market, further depressing prices.

[37] In addition to the sale of goods on credit, the practice of giving goods on consignment (memorandum), which is common in transactions between wholesalers and retailers, is a way of effecting an implicit loan.

(and an implicit interest rate) that a buyer would prefer to simultaneous exchange financed through a short-term bank loan.[38]

The economics of the diamond industry suggest that there must be a way for dealers to make and enforce executory contracts. Sections IV*B* through *E* discuss why the diamond industry opts for extralegal agreements over legally enforceable contracts and considers the two ways that these extralegal agreements are enforced. Sections IV*F* through *I* consider the efficiency implications of these arrangements and discuss the substantive and procedural reasons that arbitration is preferred to litigation.

B. The Choice between Extralegal Agreements and Legally Enforceable Contracts

One line of analysis used to explain market transactors' choice between legally enforceable contracts and extralegal contracts focuses on the transaction costs of negotiating and drafting legally enforceable agreements. It is not clear, however, a priori that these costs are necessarily higher than those incurred in the formation of an extralegal contract consummated with a handshake. Because the ability of the promisee to enforce an extralegal contract depends on the posting of a reputation bond by the promisor, each of the parties must bear the "information cost" of determining whether the other party is trustworthy before negotiation over the terms of the agreement even begins.[39] This cost may be substantial and will depend, at least in part, on 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.

[38] The Merchants Bank of New York, however, 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 intraindustry reputation information). The bank then extends short-term loans to non–sight holder dealers. The bank's policy, however, is new and it is too early to assess its success.

[39] 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. Many of these "treatments," however, cannot be detected without sophisticated equipment. Although in theory buyers could have every stone evaluated by a gemological laboratory to determine whether or not it had been altered, this would be prohibitively time consuming and expensive. Nevertheless, if a dealer purchases a "treated stone" and sells it to someone else who discovers the stone's treatment, he can be taken to the arbitration panel for failing to disclose the treatment. The panel must then 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 is an important factor considered by the arbitrators. See also note 64 *infra*.

In general, the magnitude of precontract transaction costs incurred in the formation of extralegal contracts will depend on how common such contracts are in the relevant market. In the diamond industry, extralegal contracts are the dominant contractual paradigm. Consequently, the industry is organized to minimize the cost of obtaining information about dealers' reputations.

In addition to the bourse system, which rapidly transmits reputation information, the precontract transaction cost of entering into an extralegal contract is reduced by the use of brokers. Brokers are able to gather information about individuals' reputations for trustworthiness at a lower effective cost than individual buyers and sellers because a broker's investment is less transaction specific. When a buyer and a seller invest in acquiring information about their respective reputations 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 the information acquired may be useful to them in the future, its value diminishes over time as its accuracy decreases. In contrast, a broker who has this information can shop around immediately for new trading partners for either party. As the geographical dispersion of the industry increases, brokers are becoming more important.[40]

In a market where enforcement depends on social ostracism or reputational damage, the formation of an extralegal contract depends on information about reputation. In addition, it requires adherence to enough formalities to alert other members of the relevant group that an agreement has taken place. In the diamond industry this function is served by customs such as handshakes, cachets, weight slips, and bills of sale that are able to effectively serve the channeling, cautionary, and evidentiary functions of formality while imposing minimal additional cost.[41]

[40] Despite their informational advantage, there are a variety of factors that limit brokers' 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 acquire some information about the broker's judgment and reputation. This task is cheaper, however, since it is less transaction 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. Even so, the brokerage fee of 1 percent of the price may be prohibitively high, particularly on low-profit-margin transactions.

[41] See Lon Fuller, Consideration and Form, 41 Colum. L. Rev. 799 (1941) (distinguishing between: (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

The diamond industry's preference for an extralegal contractual regime cannot be explained by the transactions costs incurred in preserving an agreement in an integrated writing. Although the industry is organized to minimize the costs of using extralegal agreements, given the widespread use of weight slips, invoices, and bills of sale, the additional transaction costs of using legally enforceable standard-form contracts would not be significant. These agreements could be drafted to approach a complete contingent-state contract because most of the events that might disrupt a transaction are well known within the industry and are subject to well-established customs and usages within the trade. Nonetheless, the use of such agreements is not observed.

In the diamond industry, even if fully specified legally enforceable contracts were widely used and could be inexpensively drafted, dealers would still incur many of the precontract transaction costs of entering into extralegal agreements. In general, as the cost of enforcing a contract in court increases relative to the expected benefit, even fully specified legally enforceable contracts contain an implicit and increasingly large extralegal component. This is also true when the expected value of the court-awarded remedy is insufficient to fully compensate the promisee. In the typical diamond transaction, litigation costs would be high relative to the amount that could be recovered, and the promisee would almost always be undercompensated under standard damage remedies.[42] Therefore, even if legally enforceable contracts were used, diamond dealers would still need the benefit of the reputation bond posted in the formation of an extralegal agreement. And, consequently, dealers would still have to incur the transaction costs of inquiring into their trading partner's reputation and conforming to industry custom.

In addition, a legally enforceable agreement, no matter how cheap to draft and easy to enforce, is not usually considered to be a positive "good" in the diamond industry. Secrecy is highly valued,[43] and whoever makes public the workings of the business will suffer a loss in the value of his reputation, even if he is merely defending himself against a meritless lawsuit. Consequently, individual traders, fearful of litigation that might reveal trade practices, prefer to conclude transactions using agreements

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expression of intention"; (2) the "cautionary or deterrent function by acting as a check against inconsiderate action"; and (3) the evidentiary function "of providing evidence of the existence and purpose of the contracts in the case of controversy").

[42] See text at Section IVC *infra*.

[43] From the perspective of insiders, secrecy raises high barriers to entry that reduce potential competition. Secrecy also helps ward off unwanted government regulation of the market.

that are enforceable only in the bourse's arbitration tribunals, where the existence and outcome of a dispute are kept secret as long as the judgment is paid promptly. Given the well-established institutional premium on secrecy, parties are rarely willing to pay the reputational price of violating that norm simply to gain access to the courts. Historically, preserving the secrecy norm is one of the primary reasons that the industry uses extralegal agreements rather than legally enforceable contracts.

Although the secrecy norm's strength has been diminishing in recent years, the industry's preference for extralegal contracts remains strong. In general, parties are more likely to opt for extralegal contracts whenever there are costs or factors that the courts are 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.[44] The same is also true when 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, extralegal 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 Extralegal Contracts Desirable to Diamond Dealers

If commercial transactions in the 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 way courts 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 most settings, expectation damages, as enforced through the courts, do not achieve their stated theoretical objective of placing the promisee in the same position that he would have been in if the breach had never occurred; they neither make the promisee whole ex post, nor give the promisor sufficient incentive to perform the promise ex ante.

[44] A similar argument is advanced by Richard A. Epstein, Beyond Forseeability: Consequential Damages in the Law of Contract, 18 J. Legal Stud. 112–13 (1989).

In practice, courts are reluctant to award compensation for lost profit since in most instances it is considered speculative. In a diamond transaction, when a seller fails to deliver a stone, lost profit is extraordinarily difficult to calculate since it is highly idiosyncratic.[45] A dealer's profit 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. The same is true of polished stones, but to a lesser degree. Similarly, when a buyer breaches a promise to pay money, it is difficult, if not impossible, to determine the profit the promisee would have made subsequent to the breach had he been able to invest the money he was owed—the value of business opportunities forgone is inherently speculative. The longer it takes to obtain a judgment, which in New York court can take up to three years, the greater will be the uncompensated loss suffered by the promissee when his ability to enter into subsequent transactions is impaired due to lack of capital.

In calculating expectation damages, courts award interest to compensate the promisee for doing without the money during the pendency of the controversy. 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 markets or excess cash on hand. For example, in a transaction between two non–sight holders, if the promisee is not paid, it is unlikely during the pendency of the dispute that he will be able to either borrow money or obtain access to the implicit capital market at the predispute implicit interest rate.[46] 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

[45] Even the expert diamantaires who sit on the DDC's arbitration panel have difficulty accurately valuing lost profit and business opportunities forgone. They are allowed to award punitive damages, however, and usually err on the side of generously compensating the promisee for alleged lost profit. They render their decisions quickly so as to minimize the number of business opportunities the promisee will have to forgo when he is not paid. See text at Section IVG *infra*.

[46] A dealer's ability to obtain credit through the industry's implicit capital market will also be affected by the existence of a public dispute. Until a decision is rendered, the judgment enforced, and the dealer absolved of wrongdoing, other dealers will be either unwilling to sell to him on credit or will charge him a higher implicit interest rate on each transaction to compensate for the perceived increase in the risk of nonpayment and the depletion of his cash reserves. Thus, even if a court were to adjust its award of expectation damages by the correct interest rate, the promisee would still be undercompensated; until the controversy is resolved, the promisee will have to pay the higher implicit interest rate in every subsequent transaction, while the court will award him interest only on the amount of the original debt. Thus, the shortcomings in the expectation remedy are particularly acute in an implicit capital market.

and highest quality goods, this is often the case, particularly for midsize dealers who operate on a tight cash flow margin. Having a portion of his capital tied up for three years while a lawsuit progresses through the New York Courts could cause a dealer extensive financial harm that would not be taken into acocunt in the final calculation of damages. In addition, when the promisor's default causes the promisee to breach other contracts, the promisee will suffer long-term damage to his reputation for which he will not be compensated under standard damage measures.

One possible way to contract around some of these difficulties would be to include a liquidated damages clause. The validity of a liquidated damage clause, however, is often uncertain because of the elusive distinction between valid clauses that are "genuine preestimates" of the anticipated damages and those that are void as "penalties."[47] In a diamond transaction, it would be particularly difficult to draft a liquidated damages clause that a court would view as a "good faith" attempt to preestimate damages. Often, at the time of contracting, the parties themselves are unable to accurately preestimate damages since the actual harm suffered by the promisee in the event of breach depends largely on business decisions made after entering into the contract. For example, even if at the time of contracting nonpayment would neither have bankrupted the promisee nor caused him to default on other obligations, if he subsequently made a large financial commitment in reliance on being paid and then was not, he might suffer tremendous financial and reputational harm, particularly if forced to go to court to obtain a judgment. Since at the time of contracting the magnitude of this harm could not have been predicted, liquidated damages clauses designed to compensate the promisee for this type of harm would run a serious risk of being invalidated as penalties. Furthermore, even if a valid clause could be drafted, the cost of negotiating its terms would greatly increase precontract transaction costs, thus depriving the clause of much of its utility.[48]

[47] The validity of a liquidated damages clause is governed by UCC § 2-718(1), which provides that: "[d]amages 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 preestimate damages."

[48] Another possibility would be to include a clause making the promisor liable for all consequential damages suffered by the promisee. 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 a businessman would agree to them.

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, Macaulay found that, even among businessmen who use legally enforceable contracts, when unforeseeable contingencies arose, there was a tendency to renegotiate contracts and settle disputes rather than resort to litigation.[49] Because expectation damages never fully compensate the promisee, all business contracts have an implicit, extralegal term that captures the value of the promisors' reputation.

D. Reputation Bonds as a Way of Enforcing Extralegal Contractual Commitments

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 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 create a system of private law enabling most transactions to be consummated and most contracts enforced completely outside the legal system.

Types of Reputation Bonds. The typical diamond transaction involves the posting of a reputation bond equal to the present value of the profit on future transactions that will not take place if the promisor breaches a contract, less his ability to cover. In practice, the value of an individual's 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 any measure of damages it finds appropriate and suspend or expel members for noncompliance with its judgments. Reputation bonds, however, are the primary reason that the arbitration tribunal's decisions are obeyed; they are essential to the bourse's ability

[49] Stewart Macaulay, Non-contractual Relations in Business: A Preliminary Study, 28 Am. Soc. Rev. 55 (1963).

to enforce its judgments. The main function of both the club and its arbitration system is to enhance the functioning of reputation bonds.[50]

Transactions between members of the same trading community also involve the posting of 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 obtain information about business opportunities is diminished. In contrast, secondary social bonds may have a value to the individual on a personal level, but their loss often will not have a direct economic effect on the promisor. When a secondary social bond is sacrificed, a dealer may experience, ''loss of opportunities for important or pleasurable associations with others, loss of self-esteem, feelings of guilt, or an unfulfilled desire to think of himself as trustworthy and competent.''[51] 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 provides kosher restaurants for its members. A Jewish health organization provides emergency medical services, and social committees are organized by neighborhood to visit sick members and their families. There is a synagogue on the premises, and contributions to a benevolent fund are required. Group

[50] 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 noncompliance results in forfeiture of a type of reputation bond that is recognized and given value by market forces.

In the early 1980s the DDC Board of Directors 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.'' The real reason the club wanted to expel Rapaport, however, was that they were opposed to his price list. See note 4 *supra*. They also brought an antitrust 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 Federal Trade Commission (FTC) to initiate an investigation to determine if the club itself was in restraint of trade. Although the FTC instituted a full-scale investigation, it was later dropped. Rapaport challenged his expulsion in court but ultimately 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.

[51] David Charny, Nonlegal Sanctions in Commercial Relationships, 104 Harv. L. Rev. 393 (1990).

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 percent of the organization's total annual income.

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. Charny has noted, however, that a reputation-bond-based, extralegal contractual regime will function even in large scale markets so long as "technology . . . such as computers used to monitor credit worthiness, or mass media used in advertising, [make it possible to] convey information cheaply to a large group of transactors . . . [that is] when a thick set of informational intermediaries" exists.[52] The diamond industry is currently in transition; it is moving from a homogeneous-group-based, extralegal contractual regime to one that relies increasingly on information technology.

The Homogeneous Group Regime. In a given market, geographical concentration, ethnic homogeneity, and repeat dealing may be necessary preconditions to the emergence of a contractual regime based on reputation bonds. As the diamond industry illustrates, however, 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.

In general, homogeneous-group-based, extralegal contractual regimes are more likely to arise when "preexisting or gradually evolving social relationships provide a basis for nonlegal [extralegal] commitment[s] without large additional investments in developing a bond . . . [since they are] incrementally less costly as nonlegal [extralegal] sanctions when they are parasitic on background habits or understandings built into the culture in which these bonds are formed."[53] Because the diamond industry has long been dominated by Orthodox Jews,[54] it was able to take advantage

[52] *Id.* at 419.

[53] *Id.* at 423–24.

[54] Jews have been involved in the diamond industry since the Middle Ages. The original reasons for their involvement were largely fortuitous: Jews happened to live in major cities on the diamond trade route. In two of these cities, Amsterdam and Antwerp, laws relating to Jewish employment were quite liberal and the governments allowed them to freely enter the diamond-cutting trade. The concentration of Jews in the industry accelerated in 1492 when Spain expelled its Jews and large numbers then fled to Amsterdam and Antwerp. For a brief history of the Jewish involvement in the diamond trade, see Abe Shainberg, Jews, Diamonds and History, 100 Israel Diamonds 46 (1987). The continued Jewish involvement in the industry has also been attributed to the fact that, due to the periodic outbreaks of

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 extralegal dispute resolution institutions. The parallels between Jewish law and 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 commercial disputes with another Jew. Should he do so, he is to be ridiculed and shamed.[55] Jewish law also provides rules governing the making of oral contracts and lays down rules for conducting commercial arbitration.[56] In the diamond industry, Jewish law provided a code of commercial fair dealing that gradually adapted to meet the industry's changing needs; yet, even as the force of religious law broke down, the system remained strong.

The stability observed in homogeneous markets can endure even if there are occasional breakdowns in the mechanism of extralegal enforce-

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anti-Semitism, Jews sought out forms of wealth that could be easily concealed, transported, and liquidated during difficult times.

[55] See Menachem Elon, ed., The Principles of Jewish Law 20–21 (1974) ("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").

[56] There are many similarities between the DDC Bylaws and Jewish law. Jewish law requires a three man arbitration panel. In complex cases, these Jewish arbiters "generally based their decisions on communal enactments . . . trade usages, . . . appraisal, justice, and equity . . . and at times even upon a particular branch of a foreign legal system." *Id.* at 23. Jewish law also reflects a preference for the voluntary resolution of disputes. Jewish arbitrators were given the authority to attempt to bring about conciliation (compromise) between 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 regular court to submit written reasons for its judgments, but an arbitral body is not obligated to do so, even upon request." *Id.* at 569. Sometimes, however, "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." *Id.* 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 ("acquistion") by one of the parties—generally the purchaser—that the other parties have expressed their agreement that this be done. Ownership thereupon 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." *Id.* at 211.

ment. Sugden developed a model of exchange that demonstrates how, under certain conditions, a market norm that normally results in cooperation 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 (breach unintentionally).[57] The game is an adaptation of the classic prisoner's dilemma model in which the following conditions hold: 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; the same must also be true for player 2; ϕ, 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 seem to hold. The probability that the transactors will have occasion to deal with one another in the future, ϕ, is quite high. In addition, many aspects of the industry 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 receiving payment on a particular date. If he is not paid, the harm he suffers can be far greater than loss of the amount of money he is owed. Nonreceipt 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 suspension from the club. Overall, he might do better forgoing the benefit of opportunistic breaches and being able to rely on receipt of payments owed.

In essence, the game relies on the familiar strategy of tit-for-tat, in which one player (say an established dealer) agrees to comply with the rules of the game until the other side violates them but will punish that player by defecting from the cooperative solution if the other player has done so in the previous round. In general, the established dealer adopts a strategy that promises cooperation to those who cooperate and punishment to those who defect. That strategy is rendered enforceable by the large number of established dealers willing to play in accordance with the rules of the game. These dealers take an initial position of cooperation and signal their future behavior by bourse membership. So long as the occasional deviations from the basic rules are met by effective punishment, the game can continue indefinitely even though there is less than perfect compliance.

Although in theory the game may be unstable since there remains a

[57] Robert Sugden, The Economics of Rights, Cooperation, and Welfare (1986).

risk of defection where the gains derived from breaching a single contract exceed the net reputational loss, in practice this is unlikely to happen since the largest stones are usually sold at public auction rather than in the club or private offices—not only to obtain a reliable market price, but also to minimize the prospect of opportunistic breach.

E. The Shift toward an Information Technology–based Contractual Regime

Although diamond dealing was one a predominantly Jewish profession, this is no longer true. Today, 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 acquaintances. As younger dealers are elected to executive positions in their bourses, however, the WFDB is considering a number of far-reaching proposals: 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 rapidly transmitting credit information. Also under consideration, although staunchly opposed by many dealers, is the creation of an international computer data base describing goods available for sale worldwide.

As the diamond industry has become less ethically homogeneous and more geographically dispersed, the WFDB had encouraged the creation of new bourses. The world federation, in this instance backed by the Central Selling Organization and its tremendous market power, has been able to induce dealers in many countries to set up bourses and pay their share of the monitoring costs needed to maintain the extralegal system. 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.

Intrabourse monitoring is an effective way of ensuring 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, and a bourse's economic viability 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 percent 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 reputations of various bourses, with particularly heavy coverage being given to new ones. 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.

Intrabourse 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, intrabourse monitoring can take advantage of preexisting social relationships and therefore be achieved at a lower cost than regulation by an outside body that cannot take advantage of these preexisting relationships.

In general, the world federation's drive to create new bourses has succeeded in combating an additional problem 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."[58] 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,"[59] 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 toward one that is based increasingly on information technology, the change could radically affect the economic structure of the industry. In a homogeneous-group-based contractual regime, developing a reputation for trustworthiness and fair dealing takes time since reputation information is communicated solely by world of mouth and depends largely on personal contacts. This results in high barriers to entry.[60] In contrast,

[58] David Charny, Implicit Contracts 50 (unpublished manuscript, Harvard Law School, Law and Economics Workshop 1990).

[59] *Id.*

[60] 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. See text at Section IVA *supra*.

Information-technology-based regimes lower barriers to entry by reducing an individual's cost of informing others about his reputation either directly or through information intermediaries such as Dun & Bradstreet, Standard & Poors, and, in the retail jewelry business, the credit ratings of the Jewelers Board of Trade.

It might be argued that an outsider with no established reputation could overcome reputation-related barriers to entry by offering to transact using legally enforceable contracts. If extralegal contracts are rationally preferred, however, a promisor offering a written agreement would have to offer a much higher price to compensate the promisee for the risk and imperfections of litigation—not only the actual cost and uncertainty of the litigation, but also the reputational damage of being involved in a court suit at all. More important, over a certain range of transaction values, a legally enforceable agreement is not of great value to a party. 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. Although, as the size of the transaction increases, the benefit of a legally enforceable contract increases relative to the transaction 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.

F. Reputation Bonds and Economic Efficiency

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. The most common type of executory agreement in the diamond industry, however, is exchange of goods today for a promise to pay X dollars on a future date. Consequently, the most common type of breach is nonpayment. On the day payment is due and the buyer has to make the decision to perform or breach, the seller's expectancy is known with certainty; it is X dollars. Since only money is at stake, and it is of equal value to both parties, performance is always indicated; the extent of a payment obligation cannot be made to turn on either party's "need" for the money. Thus, even a legal rule that 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.

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. 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 is one in which each rough stone finds its way to its highest valued use. This outcome corresponds to the manufactuer who is willing to pay the most for it since a manufacturer's ability to estimate the value of the polished stones he can make from a piece of rough is critical to his ability to earn a profit.

It might seem that, if seller (S) promises to sell a stone to manufacturer 1 ($M1$) for one hundred dollars and manufacturer 2 ($M2$) comes along and offers two hundred dollars, in the absence of transaction costs it makes no difference for market efficiency if S decides to sell to $M1$ who resells to $M2$, or if S sells directly to $M2$ and voluntarily pays $M1$ one hundred dollars. Given the structure of the market for rough diamonds, however, if S sells to $M1$, it is unlikely that the stone will wind up in the hands of $M2$. 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 cannot be more profitably cut by another manufacturer, not do they want it known that they have a particular type of rough in their possession.

Given the remote possibility of resale, a rule that makes no allowance for the prospect of efficient breach in rough diamond sales may appear to induce too high a level of contractual performance. For a variety of reasons, however, the magnitude of the inefficiencies introduced by this rule is likely to be small, especially considering the increased importance of rough brokers in the market.

One major function of a broker is to conduct an effective search for the buyer willing to pay the highest price when the value of a stone is uncertain. If that uncertainty exists, the original owner has every incentive to hire the broker to search the market. If that has been done, then the first purchaser for use will rightly conclude that hiring a second broker has a very low rate of return, given the search already undertaken by the broker for the original owner. Similarly, if the original owner did not think it worthwhile to hire a broker for the original sale, unless circumstances have changed radically or the first purchaser has better information about the market, there is no reason to suppose that he will find it in his interest to either hire a broker or search the market himself.[61] In general, a rule requiring automatic performance will induce the optimal amount of search by sellers before the first sale is concluded. Thus, regardless of whether or not a broker was used in the original transaction, first purchasers will rarely find it advantageous to resell even if they search the market.

There is another reason that a rule of automatic performance does not introduce major inefficiency in the market. The cartel has the ability to fix the price of the rough that it sells. It also has a standard practice of announcing the magnitude of the price increase at each sight. Together, these two controls keep the difference between the prices that two manufacturers are willing to pay small relative to the aggregate benefit of avoiding the deadweight cost of dispute resolution. As an additional benefit, a high level of contractual performance in the sale of rough promotes efficient reliance decisions such as hiring skilled diamond cutters in advance to cut and polish the rough.[62] In aggregate, the magnitude of the inefficiencies introduced through a high level of contractual performance of executory promises to delivery rough stones is likely to be small, particularly since contracts for future delivery of a stone are uncommon and possession is typically transferred at the time of contracting. Thus, while it cannot be claimed that the rule of automatic performance in the sale of rough diamonds will always lead to the theoretically efficient outcome, the dynamics of the market suggest that the customary solution may well be the efficient solution when the imperfections brought on by positive transaction costs are taken into account.

Another problem associated with the use of extralegal contracts enforced through reputation bonds is the cost of renegotiation, which is

[61] In those situations where the first purchaser really does have superior connections for resale, he should enter the market as a middleman. This is observed: some of the largest manufacturers with the most extensive supply connections to sight holders, who often purchase rough stones in large parcels rather than individually, also run very active brokerage businesses.

[62] Diamond cutters are independent contractors and are often 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 still have to pay the cutter. Furthermore, unlike many commercial contexts, at the time a diamond contract is made, the promisee typically is unable to estimate what is reliance expenditures will be; they will depend largely on the subsequent business opportunities that present themselves to the promisee. For example, if he subsequently promises to pay someone else and is unable to do so since he, himself, has not been paid, he will incur damage to his reputation and suffer a large loss.

likely to take place quite frequently since the "sanction [imposed in the event of breach] is much more likely substantially to undercompensate the promisee because implicit [extralegal] contract bonds often do not redound to the promisee's direct benefit."[63] Although the damage to the promisor's reputation does not directly redound to the benefit of the promisee, this problem has been largely overcome (at least with respect to transactions between club members) by the creation of the floor committee and the board of arbitrators, both of which have the authority to award damages.

G. The Substantive and Procedural Advantages of Arbitration over Adjudication

In the diamond industry, arbitration has important substantive and procedural advantages over adjudication. It enables parties to resolve disputes and enforce judgments quickly, inexpensively, and secretly, thereby containing damage to reputation and reducing the actual damage suffered by the promisee in event of breach.

Unlike courts, whose award of damages is limited by either expectation damages or a valid liquidated damages clause, the DDC bylaws allow arbitrators to 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. The authority to award punitive damages means that they can make the promisee whole, and the authority to order payment of a fine enables them to create a deterrent to breach contract. Since transactors know they may be forced to pay a penalty in the event of breach, their incentive to breach in the first place will be greatly reduced.

Although DDC arbitrators have industry expertise and sophisticated business judgment, they are not much better than courts at valuing lost profit or business opportunities forgone. Because arbitration hearings are held soon after the filing of the complaint, however, and because decisions are rendered and enforced shortly thereafter, the harm suffered by the promisee, while still difficult to quantify, is minimized. The inability of even expert dealers to accurately assess lost profit when a seller breaches a promise to deliver a stone may be the reason that possession is typically transferred at the time of contracting. Similarly, the difficulty of valuing lost business opportunities when a buyer fails to pay may account for the premium on speed: the sooner the promisee is paid, the

[63] Charny, *supra* note 58, at 5.

fewer transactions he will be required to forgo. The bourse's ability to resolve disputes promptly is considered so important that even if a dealer fails to appear for an arbitration, the hearing is held and he is bound by the panel's decision. The Floor Committee is also available during trading hours to resolve minor disputes as soon as they arise.

In disputes other than breach of a promise to pay money or deliver a stone, which are dealt with in the bylaws or according to well-established custom, arbitrators' verdicts may be more accurate and predictable than those of a court since arbitrators possess industry expertise and are permitted to consider information that would be excluded in court under the rules of evidence. If a diamond dispute were decided by a court, the application of industry custom would be highly unpredictable: unlike a DDC arbitrator, who can apply his own knowledge of industry custom, a judge would have to determine the content of customary norms from the conflicting testimony of expert witnesses. The uncertainty introduced by a judge's need to resolve conflicting testimony would greatly reduce the expected benefit to the promisee of having a legally enforceable contract.

Under the club's bylaws, the existence of a dispute and its resolution are kept secret so long as the arbitrators' judgment is paid promptly. Consequently, unlike filing a claim in court, initiating an arbitration does not affect the parties' ability to borrow or enter into implicit capital market transactions during the pendency of the dispute, which, in turn, minimizes the financial harm suffered by the promisee. The reputation damage suffered by the promisee is reduced by the practice of keeping disputes secret after a judgment is rendered since other transactors may view mere participation in an arbitration as a signal that a dealer was unwilling to renegotiate deals when unforeseen circumstances arose; they might demand additional protections or charge a higher price when dealing with him in the future.

The rapid enforcement of judgments is another advantage of DDC arbitration. Unlike a court, the DDC has the ability to bring unique pressures on the losing party to pay: it can put him out of business almost instantaneously by hanging his picture in the clubroom of every bourse in the world with a notice that he failed to pay his debt. Thus, the threat of publicity and the practice of keeping disputes secret as long as judgments are paid gives the defendant an incentive to promptly comply with the arbitrators' judgment. In addition, trade rules try to minimize the likelihood of a judgment-proof debtor in two ways: by making individual members as well as the corporations they trade for liable for arbitration judgments; and by providing for the expulsion of any member who files, voluntarily or involuntarily, for personal or corporate bankruptcy in court instead of going through the club's own bankruptcy procedure, which requires the debtor to make 100 percent restitution to his diamond industry creditors.

Although keeping this type of information about dealer behavior from a market that works largely on reputation may slightly impair the efficient operation of the market for reputation information, in the context of the diamond industry's institutional structure, there are sound reasons for this practice. Requiring arbitration judgments to be made public without introducing additional changes in the system might result in the dissemination of information that would be difficult for the market to value accurately. If only the amount of the judgment were announced, a dealer who was ordered to pay a large judgment because there had been an honest misunderstanding in a large transaction would suffer more reputational damage than a dealer who had to pay a smaller judgment because of deliberate breach or theft. Consequently, the facts of the case would have to be released to accurately convey the relevant information to the market if judgments were made public. Arbitrators would have to make findings of fact and issue written opinions, which would lead to a demand for procedural protections such as rules of evidence and more extensive discovery. In time, the flexibility and informality of the system, essential to the rapid resolution of disputes, would begin to disintegrate. Furthermore, it may be that the information most important to the reputation market is not that a dealer has been involved in a dispute or even that he has breached a contract, but rather that he has been prepared to either settle disputes or abide by the judgments of the arbitral tribunal when a third-party adjudication was necessary.

In complex cases not covered by the trade rules or industry custom, diamond industry arbitration suffers from the same weakness as most commercial arbitration: unpredictability. The lack of written decisions and a tradition of stare decisis makes it difficult for market participants to make rational breach decisions and to determine in advance the type of sanctioned behavior. In order to increase predictability, many bourses in the world federation have relaxed the norm of complete secrecy. Arbitrators publish written announcements of the principles used to decide novel cases while keeping the parties and other identifying facts secret. The WFDB recently proposed compiling a computer data base of these statements of principle to promote worldwide uniformity of arbitrated judgments and to prevent "forum shopping." They also proposed additional uniform training programs for all arbitrators. Younger WFDB officials fear that if such changes are not introduced the system will be perceived as arbitrary and unjust, and its legitimacy may decline. Recently,[64] there has been increasing pressure on the New York bourse to relax the secrecy norm and to permit arbitrators to issue policy statements in novel or complex cases—a change that would enable the industry to capture the benefits of arbitration (secrecy, informality, and speed) and litigation (the creation of precedent and stare decisis).

H. The Aggregate Efficiency of the System

The importance of international transactions 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, 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 be concerned with the technicalities of concluding legally enforceble agreements in different countries, particularly when many of these countries do not have well functioning judiciaries. The world federation maintains a board of arbitrators that 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 also avoids complex questions of international jurisdiction.

[64] A few years ago a case arose that revived the debate over the secrecy of judgments in the New York bourse. 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 that developed this process and actually treats the stones requires those they deal with to sign an agreement requiring disclosure of 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 so treated. The board of arbitrators ordered recision 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 and a dealer in exercise of ordinary care would not have been expected to ask whether or not the stone had undergone this treatment. By the time the arbitration was concluded, however, the treatment had become so well known 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. 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.

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

Diamond dealers consistently maintain that transactions between two club members, between two nonmembers, and between a member and a nonmember 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, the terms of the transaction (either substantive or price) should be different when at least one party is a nonmember. For example, a member seller who would sell a stone to another member on thirty-day terms would be expected to charge a nonmember a higher price (or perhaps demand cash on the spot) to compensate for the risk of nonpayment and the unavailability of arbitration. Dealers insist, however, that no such differences exist and that they decide who to deal with purely 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 nonmember, the nonmember has an incentive to keep 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 nonmember's wrongdoing, but he can also object to his being accepted for club membership. In transactions between two nonmembers, both parties have reason to worry about their reputations. In order to obtain a steady supply of rough to run an efficient manufacturing business, a nonmember must have a reputation of being scrupulously trustworthy. Nonmembers know that their potential future 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 were not available more disputes would go to court. This is not observed; litigation between two nonmembers 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 is also not observed. Thus, it appears that the dispute resolution institutions in the diamond industry can fairly be called extralegal: it is primarily the fear of damage to reputation that maintains discipline in the diamond trade, not the bourse's board of arbitrators or the procedural right to appeal arbitrated decisions in court.

The relative importance of reputation and arbitration may now be shifting, for dealers differ among themselves on the importance of arbitration's availability. Most claim that it is unimportant, but there are recent signs to the contrary. In the early 1980s, 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 down and dealers become increasingly focused on their "rights," arbitration will come to have a more important function. He believes that the increasing importance of arbitration and third-party dispute resolution requires more qualified arbitrators and greater uniformity of decisions and is concerned that, unless the bourses meet the challenge of providing a quick and predictable way of resolving disputes, the diamond industry's independence from the legal system will slowly disintegrate.

V. Arbitration and Settlement

With respect to simple disputes dealt within the bylaws or those dealt with according to well-established custom, the decision whether to settle or go to arbitration will depend on the usual parameters. The expected value of the arbitration to the plaintiff will be the probability of success on the merits, multiplied by the projected recovery, less the cost of legal representation if represented by counsel, less (depending on the arbitrator's whim) the cost of arbitration if he is made to bear it. The bylaws 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 dependant 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.

Conversely, the expected cost of the arbitration to the defendant is the probability of losing multiplied by the damage award, plus legal fees if 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[65] suggest that the closer the plaintiff and defendant's estimates of the expected outcome of the litigation, the more likely they are to settle. Consequently, to the extent that the required prearbitration 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, in fact, observed: 80–85 percent of the disputes submitted to arbitration are settled during the proceeding's mandatory conciliation phase.

In more complex cases—such as labor disputes, trademark infringe-

[65] See Steven Shavell, Suit, Settlement, and Trial: A Theoretical Analysis under Alternative Methods for the Allocation of Legal Costs, 11 J. Legal Stud. 55 (1982).

ments, partnership disagreements, and the use of new techniques to make flaws in stones invisible to the human eye—a party cannot simply be ordered to pay the money owed or to deliver or return the stone in question. In these cases, the arbitration panel either hears the case, or, if it falls into one of the four categories enumerated in the bylaws,[66] the parties are left free to seek a resolution of their dispute in court. When arbitrators opt to decide complex or novel cases, however, it is difficult for the parties to predict the rule of decision and/or the damage measure that arbitrators will apply. Since arbitrators neither make findings of fact nor render written opinions announcing their decisions, past decisions are a poor predictor of future outcomes. 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 also will 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.

VI. The Effect of Legal Intervention into the Extralegal Contractual Regime

In general, diamond dealers prefer to conclude agreements using extralegal contracts. Certain types of agreements made in the course of diamond transactions, however, 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.

One example is when a bank or an insurance company is a direct party to an agreement. Unlike individual buyers and sellers, banks and insurance companies do not have an interest in maintaining 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 financing.[67] Consequently, banks

[66] See text around note 25 *infra*.

[67] 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 (located in the middle of Forty-seventh Street) explained, "[i]n 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." Merchants Bank

are often able to obtain the benefit of having a legally enforceable contract, such as a standard loan agreement, as well as the implicit collateral of a reputation bond. A second example is found in transactions such as consignments, where banks or insurance companies are not directly involved, but where their rights may be affected later and the legal process invoked to resolve disputes.

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. The courts have been reluctant to credit arguments based on custom and usage, however, and generally have refused to recognize the existence of the extralegal agreement to return the goods, finding them to be the property of the consignee. As a consequence, when a consignee goes bankrupt, courts do not permit the consignor to recover his diamonds: "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."[68] Consequently, when a dealer gives goods on consignment, a formal consignment memorandum that satisfies the requirements of the Uniform Commercial Code is now sometimes drawn up to ensure that the dealer's title to the goods will be recognized by the legal system.[69] Dealers explain that the documents are designed to serve two distinct purposes. 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 abscond with the goods. The same risk of loss would be present in any sale for future payment (especially since consignment

Moved and Grew with Industry, N.Y. Diamonds, December 1988, at 38. 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.

[68] S. Herman Klarsfeld, Legal Gems, N.Y. Diamonds, May 1988, at 40.

[69] 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." *Id.* at 63. However, due to the transactions costs of drafting and filing the financing statement, they are used only in the largest transactions.

agreements and sales are often made between the same people), a situation in which dealers clearly prefer extralegal agreements. Legally enforceable contracts are sometimes used in consignments because these transactions are often interpreted in the course of legal proceedings, and without them courts tend to interpret the meaning of an intraindustry consignment agreement in ways that are strongly at odds with industry custom and the intent of the original contracting parties.

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 world's diamond bourses, combined with widespread adherence to the secrecy norm, have succeeded in maintaining a largely extralegal contractual regime where transactions are concluded on the basis of the dealers' reputations and the incidence of breach is low.

Over the past decade, however, a subtle change has been taking place—the legal system has begun to interfere with the substantive rules used to decide arbitrated cases as well as the ways in which these decisions are enforced. Under the DDC bylaws, the Board of Arbitrators can suspend or expel a member if he does not comply with a judgment. Ever since Martin Rapaport[70] decided to break the secrecy norm, however, by initiating the first suit against 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 Rapaport controversy has made the club much more reluctant to expel members—it is concerned not only about the expelled member bringing suit, but it also fears that too many expulsions will revive the Federal Trade Commission'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. Effective sanctions may still remain, however, 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.

Although the DDC bylaws have always given the litigants the right to be represented by a lawyer, prior to the Rapaport case it was uncommon. Today, 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

[70] See note 50 *supra*.

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.

VII. Conclusion

This article has been largely devoted to offering explanations of why the diamond industry has long relied on the extralegal enforcement of its business norms. By a variety of reputational bonds, customary business practices, and arbitration proceedings, the diamond industry has developed a set of rules and institutions that its participants find clearly superior to the legal system. The industry, as it has been traditionally organized, is able to make and, more important, enforce its own rules. The market is organized to promote the low cost and rapid intraindustry dissemination of information about reputation, which enables it to use reputation bonds to create intraindustry norms that function as a deterrent to breach of contract and a private sanctioning system whose judgments can almost always be enforced completely outside the legal system.

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, designed to promote the dissemination of information about reputation and socialization among members, emerged to fill the gap. That generations of diamond dealers have clung to nearly identical intraindustry norms in countries with a wide variety of legal rules and institutions suggests that the traditional rules and institutions are likely to be efficient from the perspective of market insiders. In the United States, the traditional rules and institutions endured over time and demonstrated their superiority to the established legal regime.

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 *the* way to do business, and nobody decent would consider doing it differently. Although many 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."[71]

[71] Interview with author, summer 1989.