A ROADMAP TO ECONOMIC DEVELOPMENT THROUGH LAW: THIRD PARTIES AND COMPARATIVE LEGAL CULTURE

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I. LEGAL UNCERTAINTY, CULTURE, AND DOCUMENTS OF PROPERTY

Two influential books by the Peruvian writer Hernando de Soto on the reasons why economic development takes place in some countries and not in others point to the negative effect of legal uncertainty, especially with respect to land titles and other "property documents."[1] In principle, what Mr. de Soto asserts make sense – if one cannot rely on what one believes one owns or has a right to claim as owner or contracting party, one will only invest and trade most reluctantly. Yet neither the cause nor the cure of the legal uncertainty described by Mr. de Soto is as easily ascertainable as may appear to the reader of these justly famous books. To begin with, de Soto deemphasizes culture as a cause for legal uncertainty and lack of development: "But the suggestion that it is culture that explains the success of such diverse places as Japan, Switzerland and California and culture again that explains the relative poverty of such equally diverse places as China, Estonia, and Baja California, is worse than inhumane; it is unconvincing . . . ."[2]

And although he shortly thereafter softens this assertion by stating that "the disparity of wealth between the West and the rest of the world is far too great to be explained by culture alone,"[3] culture in his world view is, paradoxically, secondary to one of its products – reliable manifestations of legal certainty. He describes these reliable manifestations as follows:

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[1] HERNANDO DE SOTO, THE OTHER PATH: THE INVISIBLE REVOLUTION IN THE THIRD WORLD (1989) [hereinafter DE SOTO, THE OTHER PATH] *and* HERNANDO DE SOTO, THE MYSTERY OF CAPITAL: WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE (2000) [hereinafter DE SOTO, THE MYSTERY OF CAPITAL].

[2] DE SOTO, THE MYSTERY OF CAPITAL, *supra* note 1, at 4.

[3] *Id.*

> The poor inhabitants of these nations - five sixths of humanity - do have things, but they lack the process to represent their property and create capital. They have houses but not titles; crops but not deeds; businesses but not statutes of incorporation . . . . This is the mystery of capital. Solving it requires an understanding of why Westerners, by representing assets with titles, are able to see and draw out capital from them.[4]

De Soto acknowledges that "representational systems" are human inventions such as musical notation or double-entry bookkeeping.[5] In so doing, however, he unwittingly accepts the cultural origin of these representations. Clearly, such notations were part of cultures that cared about music and wanted to preserve it, or cared about trade and needed to verify the accuracy of business records. Surely, they were not invented by cultures that were indifferent to these endeavors. His concentration on "representational systems," i.e., the thing or language that embodies legal certainty as contrasted with the culture that creates such a thing or language, overstates the importance of legal documents. In de Soto's words:

> In the West, by contrast, every parcel of land, every building, every piece of equipment, or store of inventories is represented in a property document that is the visible sign of a vast hidden process that connects all these assets to the rest of the economy . . . . The single most important source of funds for new businesses in the United States is a mortgage on the entrepreneur's house.[6]

Having practiced and taught commercial lending law for decades in the United States and other western countries, I can attest to the fact that a merchant's inventory is nowhere represented by a "property document." The document that describes the items or components of a merchant's inventory is most often the buyer's own purchase order or his seller's invoice, and is by no means a property document. When a merchant pledges his inventory, title to this collateral is, in the words of the Uniform Commercial Code, "immaterial."[7] And if a merchant pledges

[4] *Id*. at 6.

[5] *Id*. at 7.

[6] *Id*. at 6.

[7] UCC § 9-202: "'Title to the Collateral Immaterial' Except as otherwise provided . . . the provisions of this article with regard to rights and obligations apply whether title to the collateral is in the secured party or the debtor." Interestingly, some thriving businesses in vibrant economies such as Taiwan's do not seem dependent upon the issuance of deeds or other formal documents of property for their success. This was confirmed recently to this writer by Paul Christensen, a successful and long-term U.S. businessman-investor in Taiwan's restaurant business. Despite that neither he nor numerous other restaurant operators in Taiwan own deeds of title to their restaurant buildings, local as well as Hong Kong and Singapore based banks extend commercial credit to them. This credit is usually based upon the borrower's track record

part of this inventory by transferring possession of it to a carrier or warehouseman, the document issued by the carrier or warehouseman (although referred to in legal parlance as a "document of title") conveys only a right to the possession of the collateral and not a right to its ultimate property.[8]

It is also incorrect to assume that "the single most important source of funds for new businesses in the United States is a mortgage on the entrepreneur's house." As noted by Heywood Fleisig, one of the most knowledgeable economists on the subject of secured lending, "About half the credit offered in the United States [to merchants] is secured by some kind of movable property: about two-thirds of bank loans are secured by either movable property or real estate . . . ."[9]

The preceding objections are not intended as quibbles; they go to the heart of de Soto's argument. For, the reason why a bank in the United States finances a merchant's acquisition of inventory without a "property document" and why title to the collateral is immaterial for secured lending purposes is because of the realistic and pragmatic legal culture of the United States. Realistically, it is impossible to trace property in movable things in the contemporary marketplace to a particular owner when the same goods, part of a merchant's inventory, could be subject to numerous competing claims of ownership. Among these competing claims could be those by: a) unpaid or partially paid seller-manufacturers, wholesalers and their respective financiers and b) price-paying buyers-retailers and consumers and their financiers. Pragmatically, what matters then is not the actual documents as "representational systems" of property but whatever best performs the function of giving notice of the secured transaction to "others" and particularly to those distributor and consumer third party creditors or purchasers. Even if one were to assume that every deserving producer of goods and services would receive title to his assets, the question would still remain, and then what? What about effective credit and investment rules and procedures?

This article will illustrate how a society's business and legal culture and the regard or disregard for the rights of "others" are major causes of its economic development or the lack thereof. It will also show how a legal culture that protects

and previous business dealings with their banks. Meanwhile, official functions such as health and fire inspections of these restaurants continue to be performed by Taiwanese authorities aware of the absence of property deeds. I asked Mr. Christensen if to his knowledge this lack of legal documentation was true for other Taiwanese businesses and he answered affirmatively. I do not advance these illustrations in support of the argument that legal documentation is not helpful for economic development purposes, for I believe it is. The illustrations are provided to show that legal documentation, while helpful to economic development, is not its universal, necessary, and sufficient condition.

[8] See Official Comment to U.C.C Section 1-201(15) which explains that the ruling in *Hixson v. Ward*, 255 Ill. App. 505 (1929) was expressly rejected by the drafters of the definition of "document of title" because it included under such a heading a document purporting to transfer title from a conditional seller to a buyer.

[9] *See* Heywood Fleisig, *Secured Transactions: The Power of Collateral*, 33 FIN. & DEV. 44 (1996) *available at* http://www.imf.org/external/pubs/ft/fandd/1996/06/pdf/fleisig.pdf.

these "others" (many of whom are known in legal parlance as "third parties" or regular bona fide participants in the marketplace acting as buyers, sellers, creditors or borrowers and their intermediaries) facilitates the emergence of a thriving commercial marketplace. Finally, it will illustrate how a famous judge's protection of the rights of "others," and especially of third parties active in the marketplace, has contributed to a legal culture of certainty and economic development in the United States.

II. BUSINESS AND LEGAL UNCERTAINTY AND "THE OTHERS"

One of the most common manifestations of business and legal uncertainty occurs in a culture in which doing business is regarded by many as a tricky, "winner take all, loser take none" endeavor or zero sum game. In such a culture, only the economically powerful, politically well connected or unscrupulous are the assured winners. Such an uncertainty was apparent among Costa Rican potential investors as documented in studies conducted by this writer during the 1960s.[10] Many local investors did not invest in ostensibly highly profitable businesses because they anticipated that, by hook or crook, the promised profits would be distributed only to the family members or close friends of the business owners. When interviewed, many potential investors expressed their distrust thusly: "If the investment is as good as claimed by these businesses, why would they want to share it with us, who are neither their family nor their friends?"[11]

This distrust is not a product of non-existent or insufficient documentation of rights but of what is regarded as typical behavior of businesspersons who are neither family nor friends of the investors. As such, it is not likely to be cured by better documentation of rights or, as will become apparent later in this article, even by Draconian enforcement of these rights. Furthermore, it is not the kind of uncertainty that an investor can insure against because unlike the rights of the privileged few, the rights of "the other" investors or traders are at the mercy of the powerful and well connected.

In the final analysis, business and legal certainty depends upon traits such as the contracting parties' willingness to share with others some basic truths about their wares or assets or their faithfulness to their promises. Underlying such a sharing and faithful behavior is the regard for the rights of such persons or entities, including in that category not only the parties with whom one contracts but also those third parties likely to be affected by such contracts. Such behavior ultimately leads to a view of contract as a cooperative joint profit-making venture and encourages a wider assumption of risks by businesspersons. It is now necessary to identify the legal

[10] *See generally* Boris Kozolchyk, *Toward a Theory on Law in Economic Development*: The Costa Rican USAID – ROCAP Law Reform Project, 4 ARIZ. L. REV. 681, 720-721 (1971) [hereinafter Kozolchyk, *Toward a Theory*].

[11] *Id.*

principles that have shaped the treatment of "the other" in *archetypal* pre-commercial and commercial cultures.

III. PRE-COMMERCIAL SOCIETY, DENSE RELATIONSHIPS AND THE OTHER; ITS LEGAL PRINCIPLES

In a pre-commercial society, i.e., one lacking organized markets for the exchange of goods and services, contractual-like duties exist by which one person feels obligated to do or give something to another as part of a relationship of reciprocity that involves the members of a family, clan or tribe. This exchange is part of what anthropologists describe as a "dense" relationship.[12] It includes the continuous supply of goods, services and favors including personal or familial protection in exchange for equivalents given by their recipient immediately after the supply or some time in the future. Thus, in some African tribes, one who lends services to another member of his/her tribe frequently does not demand payment corresponding to the actual value of the services, but instead anticipates the return of repayments over a period of time and for a value approximating the original value.[13] These duties of reciprocity are owed only to members of one's family, clan or tribe or to allies in other social groups, but are not owed to strangers. In fact, membership in a family, clan or tribe that is not one's own may well qualify such a person for treatment as an enemy. Dense relationships are governed by informal, although discernible, legal principles, some of which will be briefly described below.

A. Valuable property is one not to be sold.

In a pre-commercial society that depends upon agriculture for its survival, valuable property, i.e., property that provides sustenance for the family or closely-knit social group, is one not to be sold or if sold in case of economic necessity, not easily. The law of pre-commercial society discourages such sales by imposing severe restrictions on it. For example, the Hindu law doctrine of "necessity" prohibits the

[12] Among the anthropologists that described the various systems of reciprocity were Bronislaw Malinowski's classical studies on the Trobriand islands. *See* BRONISLAW MALINOWSKI, CRIME AND CUSTOM IN SAVAGE SOCIETY (1926). See E. ADAMSON HOEBEL, THE LAW OF PRIMITIVE MAN 180-86 (1954), for an insightful analysis of Malinowski's contribution to the effect of reciprocity upon law. See also CARLOS VELEZ-IBANEZ, BONDS OF MUTUAL TRUST: THE CULTURAL SYSTEM OF ROTATING ASSOCIATIONS AMONG URBAN MEXICANS AND CHICANOS (1983), for more recent studies on dense relationships in contemporary urban environments. For an insightful legal analysis of dense relationships, see James Gordley, *Contract in Pre-Commercial Societies and in Western History*, 7 INT'L ENCYCLOPEDIA OF COMP. L. 5 (1997).

[13] Gordley, *supra* note 12, at 6.

sale of family or ancestral property except to satisfy urgent family needs and never for "frivolous" purposes.[14]

B. Sellers and grantors often have to assume an indefinite and unlimited liability to their buyers-grantees.

In pre-commercial societies, sellers who must sell valuable family property often remain liable for the defects of the real or personal property conveyed for a much longer period of time than is typical in societies with organized markets. For example, Jewish sellers of land in fourth century B.C. Egypt and their descendants remained liable to defend the title of the land virtually indefinitely as a result of their "defension" clauses.[15] Similarly, in certain parts of Africa today, a seller of pigs remains liable to his buyer if, following the sale, one of the pigs sold becomes ill or does not eat well during an unspecified period of time, regardless of whether the seller is at fault.[16] And even though among the Ifugao of the Philippine islands "the taking of an enemy's head is religiously and magically necessary," it is also true that "a debt never dies."[17]

The long-term and often accumulating liability of an obligor or grantor of valuable property in pre-commercial society forced the creation of legal institutions to mitigate this liability. For example, in certain regions in India that until very recently depended on a subsistence agricultural economy, unpaid interest was accumulated without limitation from one generation to another on members of the same family of the original debtor. To prevent such accumulation, Hindu law created the doctrine of "*damdupat*" that limits the aggregate amount of cumulative interest: interest cannot exceed the principal amount of the obligation.[18]

C. An agent can only benefit (but not harm) his principal, often at the expense of other parties.

[14] Even in contemporary Hindu law, if an administrator of a family estate sells valuable property, such as the family land with the purpose of, say, supporting a mistress or throwing lavish parties, the heirs of that estate can recover the land from third parties, in many cases sine die. *See generally* Boris Kozolchyk, *Transfer of Personal Property by a NonOwner: Its Future in Light of its Past*, 61 TUL. L. REV. 1453 (1987) [hereinafter Kozolchyk, *Transfer*].

[15] *Id.* at 1468. *See* REUVEN YARON, INTRODUCTION TO LAW OF ARAMAIC PAPYRI 79-82, 85 (1961).

[16] Gordley, *supra* note 12, at 7.

[17] HOEBEL, *supra* note 12, at 104.

[18] Boris Kozolchyk, *Fairness in Anglo and Latin American Commercial Adjudication*, 2 B.C. INT'L & COMP. L. REV. 257-58 (1979) [hereinafter Kozolchyk, *Fairness*). *See, e.g.*, The Punjab Relief of Indebtedness Act, 1934, DAMDUPAT. 30. punjabrevenue.nic.in/Indebtact34.htm, and others in Google, voice Damdupat. (for present day applications of the doctrine of Damdupat in Hindu law).

Another legal principle of pre-commercial society is that an agent, even when he discloses the name of his principal, does not bind such a principal to the third party, person or entity with whom the agent has dealt. This principle reflects a greater concern for the rights of one's principal (usually a member of one's family, clan or tribe) than of third party strangers. Commonly in agricultural societies such as those of the Hebrew Bible, an agent could not harm his principal; he could, as often stated in rabbinical interpretation of Biblical rules, "only benefit him."[19] Thus, an agent who exceeded his authority was personally responsible to the third party, but his principal remained immune against claims by third parties.[20] Significantly, largely as a result of the formalities of the law of agency and powers of attorney in developing nations, this immunity is still in force in some of these nations.[21] Needless to say, few third parties will want to deal with agents for disclosed or undisclosed principals who are not bound by their agents, and if they do, the cost of the transaction will reflect the high legal and commercial risk assumed by the third party.

D. Executory promises or promises of deferred performance are mostly unenforceable.

[19] Kozolchyk, *Transfer, supra* note 14, at 1453, 1468.

[20] *Id.*

[21] For example, in an unreported Mexican appellate court decision circa 1950, involving the then president of the Cerveceria Moctezuma, one of Mexico's largest breweries, the president of this brewery claimed that his signature on a check paying for the purchase of raw materials for the manufacture of beer did not bind his company. The alleged (and court accepted) reason was that the president's power of attorney and company's by-laws did not authorize him to enter into the acquisition of raw materials underlying the issuance of the check. Results like this forced Mexican banks to request from their commercial checking-account customers certified copies of their corporate officers' powers of attorney and certifications from the Commercial Registry indicating that the relevant powers had been registered. Needless to say, such a presumption of authority imposes hardship upon bankers who must act as legal experts when determining the authority granted by powers of attorney. It imposes even greater hardships upon non-banking payees and holders of the checks who are expected to verify the authority to sign negotiable instruments.

Not surprisingly, Mexico's appellate courts have had to attenuate the rigor of the non-presumptive approach to powers of attorney with respect to endorsements for collection of negotiable instruments. They have stated in at least five consecutive decisions that articles 35 and 39 of the Mexican Law of Negotiable Instruments and Credit Transactions (August 26, 1932) allow endorsements for collection purposes without the need to prove the capacity and authority (referred to as the legal personality) of the endorsers. To require such proof, especially after these instruments had been endorsed by several legal entities, would have been contrary to the spirit of the law.

Pre-commercial societies only exceptionally enforce "simple" executory promises or promises of a future performance that are not accompanied either by special formalities or by an immediate exchange of goods or services. Comparative legal historians have confirmed this trend even in incipient commercial societies such as that in classical Roman law.[22] As late as the 1970s, some Native Americans are reticent to issue executory promises. Thus, when a former student of this author conducted a field study that compared Uniform Commercial Code (UCC) sales law with the tribal law of the Zuni Indians of New Mexico, he reported as follows:

> I asked the silversmith in charge of jewelry production in the tribe how he documented a promise to sell jewelry, i.e., in a contract signed by both parties or by an annotation in a book or record. He seemed perplexed and asked me: "What promise are you talking about?" I responded that it was the promise he made to those buyers who ordered a quantity of jewelry that he couldn't supply at that moment. "I don't make such promises," he stated firmly. "I only sell what I have at hand. I don't know what's going to happen in the future." I asked him if his colleagues agreed with him. He said that all of them felt the same way.[23]

Obviously, the inability to enforce simple promises of deferred performance reduces considerably the scope and range of credit transactions in pre-commercial societies.

E. Disputes are mostly compromised, not formally adjudicated.

Most of the disputes concerning the lack of reciprocity in dense relationships are resolved by a compromise formulated by one or more elders or respected members of the tribe. This adjudication is informal in the sense that it does not attempt to establish methodically and objectively the intervening facts or the law applicable to them.[24] Instead it evaluates the effects of the alleged breach upon the long-term relationship of the parties and their peers and fashions a remedy to preserve such a relationship.

As noted by Professor Gordley, one of the disadvantages of this system of adjudication is the likelihood of an unfair adjudication of the individual transaction

[22] *See generally* GINO GORLA, 1 EL CONTRATO 20-22 (Barcelona, 1959).

[23] Memorandum from Chester Jones, JD student, University of Arizona, James E. Rogers College of Law to Boris Kozolchyk, Director, National Law Center for Inter-American Free Trade (May 12, 1972) (on file with author).

[24] *See* HOEBEL, *supra* note 12, at 125 (for an interesting analogy between the Monkahun compromise procedure among the Ifugao and Western society's mediation in international disputes).

for the sake of preservation of a long term relationship, especially where the reciprocity is measured by a generalized balance of the reciprocal contributions at the end of a given period.[25] Given the lack of predictability of a dispute involving an individual transaction, whoever relies on the likely profit from such a transaction will suffer a detriment.[26] The predictability of law applicable to future transactions similarly suffers because of the absence of factual findings and transactionally inspired rules; the clearer the transactional basis of a rule is, the more predictable is its application.

IV. A THRIVING COMMERCIAL SOCIETY AND ITS LEGAL PRINCIPLES

Unlike pre-commercial society, a thriving commercial society relies on organized markets for its exchange of goods and services, and contractual rights and duties are bargained for not only among members of that society but also between these members and members of other societies. Some of the legal principles that guide its law of commercial transactions are the following.

A. The inevitability of certain forms of doing business and their underlying legal principles.

The first principle that guides lawmaking in a thriving commercial society is that of inevitability: in attaining certain economic goals, only certain ways of doing business, inspired by the best practices of a given business and legal culture, are possible. Thus, it is not accidental that during the late Middle Ages and the Renaissance, credit and payment instruments began resembling the format of letters (reflecting the communications that accompanied the increased travel of merchants, goods, services and currency), or that business associations distinguished between active and silent partners (reflecting the need to attract investment capital assured of limited liability), or that double-entry bookkeeping became generalized (reflecting the need to verify the accuracy of the book entries of partners, joint venturers and money lenders). These institutions were the result of best business and legal practices. It is also no accident that trading centers during the same period had to come up with clever disguises for commercial loans (renaming them partnerships, sales, or leases), for usury was still defined as any amount charged as interest. Had such a restrictive definition continued to prevail during the Renaissance, many a

[25] Gordley, *supra* note 12, at 9-11.

[26] *Id.*

European economy of subsistence would not have been transformed into a thriving commercial society.[27]

During the negotiations of the North American Free Trade Agreement (NAFTA), Mexican and United States negotiators became aware that small and medium sized Mexican businesses suffered from a crippling competitive disadvantage with respect to their Canadian and United States counterparts. The reason was that Mexican businesses, unlike their NAFTA competitors, lacked access to commercial credit at reasonable rates of interest. Shortly after the signing of NAFTA, this author suggested to one of Mexico's negotiators that commercial credit at reasonable rates of interest could become available to Mexican merchants if Mexico enacted a secured transactions law compatible with the laws of its northern neighbors. My interlocutor replied with exasperation: "Why is it, that Mexico is always expected to harmonize its commercial laws with the laws of Canada and the United States and not the other way around?" My reply was that the relevant question was whether Mexico wished to make commercial credit available to its small- and medium-sized businesses. If it did, then it could not ignore the legal principles upon which such credit depended. One such principle was the secured creditor's need for quick and inexpensive access to accurate and timely information about his debtor's assets and ability to repay. Another principle required that, in light of the perishable (and quickly value-losing) nature of much collateral, its recovery had to be quick, inexpensive, and extrajudicial. Thus, if Mexican law tolerated a good number of secret or unrecorded liens and did not provide for a quick and extrajudicial repossession procedure, such a law and method of doing business would be unacceptable to secured lenders regardless of who enacted that law.

In sum, the inescapable fact is that some legal principles encourage desirable commercial transactions while others, such as those discussed in connection with pre-commercial society, do not. The following are some of the most important principles that make key commercial transactions possible and thereby encourage the economic development of a commercial society.

B. Parties should be free to bind themselves in a manner that does not violate the law or public policy, regardless of the type of contract and its formalities.

Contrary to the prohibition or discouragement of pre-commercial society of the trade of one's or one's family's most valuable items, commercial society presupposes freedom of contract especially with respect to those assets that are considered valuable. In this respect, Article 1134 of the French Civil Code of 1804 proclaimed an essential principle of both commercial contract law and of economic development: "Agreements legally formed have the force of law between the parties .

[27] *See* BENJAMIN NELSON, THE IDEA OF USURY: FROM TRIBAL BROTHERHOOD TO UNIVERSAL OTHERHOOD 3-29 (2d ed. Univ. of Chi. Press 1969) (the definitive work on the evolution of the idea of usury).

. . ."[28] Yet, while this principle "enfranchised" many contracting parties who could not contract with each other under the *ancienne* (feudal) *regime*, the same code's classification of contracts has led interpreters, especially in developing nations, to the conclusion that only those contracts classified or listed in their (French-inspired) codes are legally enforceable.

This *numerus clausus* approach is responsible, for example, for the rejection in commercial credit starved Central America of those secured transactions that are not listed as enforceable contracts in their respective civil and commercial codes.[29] The same restrictive approach and economic consequences are apparent with respect to contractual formalities. For a host of cultural reasons, including the ability to centralize political (and legal) powers when legal documents are endowed with a ritualistic magic performed only or best by state appointed "lawmen," developing nations are more likely to require formalities for the sake of formality and not as means to facilitate marketplace transactions. Some formalities, to be sure, can facilitate legal certainty by performing the desirable function of, say, giving notice of the existence of the transaction to third parties or discouraging fraud. Still, those legal systems that require formalities *ad solemnitatem* and deny validity to otherwise economically desirable transactions run the risk of excluding themselves from some of the most economically significant markets of our day, including the highly informal (and electronic) global financial marketplace.[30]

Thus, contrary to principles (b) and (d) above of the pre-commercial society, in a thriving commercial society there is little or no room for a closed number of typified contracts or for *ad solemnitatem* formalities. And where they exist, they should not impede the parties' ability to assume or limit their liability by contract or by choosing the appropriate form of business association.

Similarly, and contrary to principle (e) of the pre-commercial society, merchants and non-merchants in the commercial society should be free to bind themselves by means of their "simple" promises, i.e., promises devoid of special

[28] Dalloz, Code Civil Article 1134 (1995).

[29] *See* Boris Kozolchyk, El Derecho de Garantias Mobiliarias en Guatemala y otros Paises Miembros del Cafta-Recientes Iniciativas de Reforma Legislativa 24, 29, 31 & 40 (Reporte al Ministerio de Economia de Guatemala, 2004) (referring to the *numerus clausus* approach in the codes of Costa Rica, El Salvador and Guatemala) (on file at the National Law Center for Inter-American Free Trade).

[30] As a member of a multinational task force for the drafting of rules on investment securities (stocks and bonds) that are created, traded, pledged, set off or "netted" by means of electronic book keeping entries, this author asked his colleagues what would be the best argument to convince Latin American government officials and their legal advisers of the need to adopt a law that would do away with the requirement of a formal writing in order to effectuate the above transactions. Lawrence Brandman, a lawyer for Goldman Sachs, one of the world's most active investment bankers and underwriters, replied immediately: "I would use only one word – liquidity. If your interlocutors wish that their government bonds be liquid, i.e., readily and inexpensively convertible into cash in the present global financial marketplace, they can no longer insist on the formality of a stamped and ribboned piece of paper."

formalities, including the co-contracting party's acceptance of the promise or the payment of a consideration for their issuance. As also noted earlier, what is at stake where this pre-commercial society prohibition against executory promises is preserved, is the unenforceability of informal credit or deferred performance promises which amount to a significant percentage of the transactions in the global financial marketplace.

C. Contracts should be interpreted whenever possible in the light of customary practice and of marketplace and brotherly fairness.

The predictability of disputes involving commercial contracts results from rules and principles of interpretation consistent with the customs and practices of regular participants in the marketplace. A rule or principle contrary to customary practice is also contrary to the reasonable expectations of the participants in that marketplace and thus causes costly uncertainty among them. But there is more. To regular marketplace participants, the outcome of the practice or a dispute about it must be cost effective and fair. *And, a fair practice is one that reflects the willingness of a marketplace participant to treat the other as he would want to be treated himself. In other words, when entering into a contract, the marketplace participant must be willing to live by the golden rule of equal treatment of equals.*[31] He is entitled to seek his own profit, but he should not prevent the other party from seeking and obtaining his profit as well. Hence, I call this standard of fairness the marketplace standard.

Occasionally, however, in transactions in which one of the parties lacks the knowledge or economic power of the other and entrusts the latter with his assets, a higher standard of diligence and morality than that of the marketplace standard must apply to the entrusted party. Simply put, he has to treat the other party to that contract as a protected brother. Since this "brotherly" standard can be highly demanding and costly, it is the mark of a good adjudicator to know when and how to apply it.[32]

D. Legal certainty in a commercial society requires a principled and reasoned adjudication as well as rules of limitation and finality of liability.

Unlike in a pre-commercial society, uncertainty in a commercial society is not the product of excluding strangers from a tribal marketplace or of denying their

[31] *See* Kozolchyk, *Fairness, supra* note 18, at 219-54; *see also* Boris Kozolchyk, *The Commercialization of Civil Law and the Civilization of Commercial Law*, 40 LA L. REV. 3, 6-47 (1979) [hereinafter Kozolchyk, *Commercialization*] (for a comparative and historical discussion of the various legal standards of fairness).

[32] *Id.*

entitlement to profit-making. It is caused by the unpredictability of the outcome of legal disputes. Thus a merchant in a commercial society should be able to assume that, as a rule, he will be entitled to payment for what he sold, lent, exchanged or leased. However, this merchant cannot be sure of payment or repayment if he breached his own contractual or extra-contractual (tort) obligations or if his debtor has a valid cause not to repay his debt. Nor can he predict the superiority of his rights over the rights of competing creditors unless he took the necessary steps to assure his superiority.

Clearly, these are very general principles of uncertain application to the transactional facts to which they are supposed to apply. Between these principles and transactional facts lie a limitless number of disputes that must be adjudicated in a manner that allows business people to calculate their legal risks, costs and profits consistently with their business sense. In other words, for a decisional rule to be predictable, it cannot be commercially counter-intuitional.

Consistent with the marketplace standard of fairness, if a businessperson were to attempt to calculate, for example, the damages for which he would be responsible if the quality of the products sold to another merchant were not what he promised, his damages should approximate those foreseeable by regular participants in that marketplace. *Mutatis mutandis*, if the transaction were one of a brotherly type of entrustment, his damages should be consistent with the liability attributable to a merchant acting in a brotherly capacity.

This is a calculus that requires the ability to expand the application of a narrow rule to the facts of a new transaction despite the narrowness of the rule, or the ability to narrow the application of a general rule to transactional facts despite the generality of the rule. And this can only be accomplished when the adjudicator: a) interprets the narrow rule *by analogy* to another set of facts or subsumes these facts under the same legal principle, or b) when he interprets the general rule narrowly enough to identify the facts in question in a manner distinguishable *from other sets of transactional facts*. Absent such an interpretation, legal prediction becomes questionable. As will be apparent in a subsequent section, not all adjudicators have such an interpretational skill. Yet, those who have it can shape commercial certainty for generations.

Aside from a predictably fair application of the law to commercial disputes, a commercial society, unlike its pre-commercial counterpart, requires rules that enable marketplace participants to *limit their liability to amounts* set forth by the law, agreed upon by the parties or both. It is precisely the need to be able to calculate likely profits and losses prior to trading or investing that makes this *ex ante* limitation of liability necessary.

Finality of liability is necessary when *the length of exposure to a commercial or legal risk* can impede the certainty of marketplace transactions and prevent the entry into other transactions. Transactions can be either infrequent or frequent; they can involve a small or discrete number of participants or a large number of simultaneous or successive, chain-like, participants. Generally, the time within which the exposure should cease is longer when the marketplace transaction is infrequent or sporadic and involves only a small or discrete group of participants. Thus, where the transaction takes place once in a lifetime, or only in a number of years, such as the sale of a residential or a business building that generally involves only a seller, a buyer and their financiers, the agreed upon or prescribed time for allowing the buyer to claim defects in the building or its title can be measured in terms of months and, in some instances, years from the time of his inspection or learning of the defect. Similarly, the seller's time to claim payment of the purchase price can be measured the same way. However, unlike the Hebrew subjects of the defension clauses, or the Hindu pre *damdupat* debtors or their Ifugao counterparts,[33] the contemporary commercial seller and buyer of the building participants in an active credit market need to know the approximate period of time during which they need to allocate or reserve assets to defend against or pay for imposed or assumed liability.

The contrast between the pre-commercial and commercial society attitudes toward finality of liability is dramatically illustrated in the manner in which contemporary check deposits, collections and payments are carried out in the United States. Consider the situation of a bank that receives, each day, thousands of checks drawn against it by its customers, and which is presented for payment by its numerous correspondent banks throughout the United States. (This bank will be referred to hereafter as the paying bank "PB," and its correspondent, intermediary banks in the chain of collection will be referred to as IB's). Shortly after thousands of these checks are deposited by their payees (the creditors of PB's customers) with their respective banks (known as banks of first deposit or BFD's and whose number can also be in the thousands in an active commercial center such as in the United States), these BFD's give provisional credit for these checks to their depositors. The provisional credits are entered in the books of the respective banks as credits in favor of the depositors and debits against the BFD's for a period of time usually measured in days. Thereafter, the same checks are deposited with IB's which likewise provide the BFD's with provisional credits and which finally present the checks for payment to the PB.[34]

What would happen if PB decided to debit its customers' checking accounts for the value of the thousands of checks deposited immediately upon their receipt and verification of the existence of funds in the respective accounts and to wait, say, a month before it paid or credited the IB's? Would not PB enjoy a free (not subject to interest payment) use of the funds deposited by its customers while the IB's, BFD's and their customers would be deprived of the use of these funds? Thus for a month's time, assets worth many millions of dollars and that rightfully belonged to thousands of IB's, BFD's and their customers would be tied up awaiting PB's payment and final

[33] *See supra* Parts III.A.-C.

[34] See Boris Kozolchyk, *Negotiable Instruments and Bank Deposits and Collections, in* III UNITED STATES LAW OF TRADE AND INVESTMENT 22-104 (Boris Kozolchyk & John F. Molloy eds., 2000) [hereinafter Kozolchyk & Molloy] (for a description of the deposit, collection and payment of checks in United States law and practice).

debits and credits. It would also mean that during the month of what is known in banking parlance as the "float," there would be no certainty as to the successive thousands of provisional credits and their final entitlement. In perpetuating unnecessary uncertainty and temporarily appropriating funds that belonged to others, clearly the PB would violate an elementary marketplace standard of fairness. Hence, there is this need for rules of finality which direct PBs, and subsequently the IB's and BFD's, to pay or give credit for the deposited checks within a short period of time (measured in days or hours) after receipt of the checks or their value for payment or credit. In short, without rules of finality, it would be very difficult to conceive of a thriving check deposit and collection business and the economic benefit it entails. The same could be said for other voluminous and speedy transactions in the investment securities and commodities markets.

E. Third parties ought to know when and how they are protected. However, the choice of third parties entitled to legal protection and the type of protection provided are among the most difficult of legislative, administrative and judicial determinations.

1. Not all the "others" who can qualify as third parties are entitled to legal protection.

The legal protection of a qualified third party is one of the most important elements of the legal certainty of a commercial society, especially in the contemporary global marketplace. For as noted earlier, ours is a world of third party strangers. Statistically, the number of contracting parties who know their co-contracting parties or who have had previous dealings with them is insignificant when compared with the dealings among total strangers. Additionally, not many legislators and judges are aware of who the third parties are who qualify for special protection and why they are entitled to such protection.

In traditional legal parlance, a third party is a stranger to the contract, negotiable instrument or secured transaction entered into by previous parties. In principle, such a stranger deserves protection because, despite not being a party to the earlier transactions, he may be affected adversely by them. Examples of such affected third parties who may be entitled to legal protection in different legal systems are too numerous to enumerate. The following are illustrations of likely candidates for such protection: 1) PH, a prospective homeowner who after searching the land registry and finding no liens or adverse rights in Blackacre buys it from S, the seller, only to discover that S had already sold Blackacre to a second buyer, SB, and SB has been in possession of Blackacre for more than the statutory period of adverse possession; 2) ML, PH's mortgage lender, who also relies on the land registry recording that shows PH as the owner of Blackacre and also ignores the fact that SB has been in possession of Blackacre for more than the statutory period of adverse possession; 3) CB, a commercial banker, who purchases a promissory note, draft, or check from RM, a retail merchant who was handed these instruments by BC, a buyer of the consumer goods sold by RM; BC refuses to pay the note, draft or check in the hands of CB, alleging defects in the goods he bought from RM; 4) CB, the same banker who purchased the negotiable instruments from RM, deposits them for payment with PB, the paying bank against which the check is drawn. PB pays the instruments to CB but is asked to pay again to RM because the latter's endorsement to CB was forged; 5) BC (the same buyer of consumer goods in the ordinary course of business from RM) is asked to return the goods he bought or pay for them again to W, a wholesaler who was not paid for the goods he sold to RM; 6) BLC is the beneficiary of a letter of credit issued to him by IB, an issuing banker, on behalf of I, an importer; I becomes insolvent, and IB refuses to pay BLC because I's insolvency will prevent IB from being reimbursed for the issuance of the letter of credit; 7) BIS, a buyer of investment securities from BD, a broker dealer, pays BD for the securities he bought, but is denied possession of them until he pays FBD, the first broker dealer from whom BD bought the securities; and 8) BIP, the beneficiary of an insurance policy, is denied payment of that policy by the insurer because shortly before OP, the owner of the policy, died, he failed to pay his last installment (after twenty years of paying installments).

In addition to these candidates for third-party protection, presently third-party-*like* protection is also being extended by some legislatures, courts, and administrative agencies to contracting parties who deserve to be treated better than other contracting parties because they are victims of the other contracting parties' seriously negligent or overreaching conduct, especially where such negligence or overreaching could not have been detected by the victims and endangers the victims' ability to continue to participate in marketplace transactions.

Depending upon a number of factors, some third parties will qualify for third-party protection and others will not. Among these factors are the following: a) the third party's ability to access adequate sources of information on pre-existing transactions and rights that might adversely affect him/her by means of legally acceptable "notice" or "publicity;" b) the third party's personal knowledge of the pre-existing transactions; c) the third party's good faith, occasionally requiring honesty, absence of malice, a measure of diligence or a giving of value; and d) the economic impact of not protecting a certain class of third parties.

2. Third-party protection entails immunity from actions or defenses by parties to the preceding or subsequent transactions.

A protected third party is likely to enjoy better rights and will be subject to fewer duties than those enjoyed by his predecessors. For example, assume that in the preceding fourth illustration, the legislator or judge decides to protect the CB (the commercial banker who innocently purchased the forged checks or drafts) instead of protecting PB (the bank which innocently paid on the check), or RM (the merchant victim of the forged endorsement), or BC (the buyer of consumer goods who innocently drew the check whose endorsement was subsequently forged). This choice means that among three innocent parties, CB was immune against an action by his predecessors BC and RM and his successor PB attempting to recover the payment made to it by the latter. It also means that CB was preferred as a member of a distinct class of market participants, i.e., those who earn their livelihood by buying checks and other commercial paper from merchants or other banks. A choice such as this must take into account the effect it will have upon the willingness of buyers of consumer goods to pay with checks or depositary banks to pay readily on checks drawn on them.

Facing such a choice, the legislator, judge, or administrator may decide, as did an administrative agency in the United States, that BC, the buyer of consumer goods, was the party who deserved protection.[35] As such, BC was given a valid defense and a right to not pay RM (the merchant who sold him the defective goods), CB (the bank which bought his draft or check), or PB (the bank that finally paid it). BC's defense against CB and PB of having been sold a defective product by RM, even though it related to a transaction that preceded CB's purchase of the consumer paper and PB's final payment, disqualified these two parties from third party protection. In this case, then, it will be the class of consumers who are given the protection as a third party, in preference against other classes and candidates for third-party protection.

3. The Vital Credit and Cash Flow Pyramid

The protection of consumers as third parties is a result of the dependence of a commercial society upon a vital credit and cash flow pyramid whose base is populated in an ascending order by consumers and then retail merchants and their respective lenders. The middle layers are inhabited by, also in ascending order, wholesalers and subsequently the manufacturers and their financiers. The top is inhabited by central banks or banks which provide the credit of last resort to the lower layers of participants in the marketplace. Simply put then, unless consumers continuously buy and borrow, the flow of credit and cash that finances and pays for retail and wholesale merchandising as well as for manufacturing will be insufficient to support existing levels of commercial activity. This is a pyramid, therefore, in which the cash and commercial paper that flow to the top subsequently flow down as credit to each of the successive layers of participants. Not surprisingly, "consumer confidence" (implying a willingness to spend) is a vital measurement of the health of a commercial society. Moral considerations aside, the lack of protection of consumers against harmful or unconscionably priced products, as well as against the

[35] *See* Federal Trade Commission, *Preservation of Consumers' Claims and Defenses, Final Regulation, Proposed Amendment and Statement of Basis and Purpose,* 40 FED. REGULATION 53505, 53524 (Nov. 18, 1975) codified at 16 C.F.R. § 433 (1978) discussed in Kozolchyk & Molloy, *supra* note 34, at 22-24-26.

overreaching and exploitation by their suppliers, undermines the soundness of the base of the credit pyramid.

4. The Consequences of Choosing the Wrong Third Party

The wrong choice of a protected class could well mean its disappearance as a market participant. If United States commercial banks had not become heavily engaged in the credit card business, and had credit card receipts not been sold to protected third parties (including banks acting as "special purpose vehicles") in the "securitization" process,[36] their loss of immunity as purchasers of consumer negotiable instruments could have meant their end as purchasers of consumer originated paper. The following decisions by a Costa Rican judge of first instance and by the Supreme Courts of the United States and Mexico will illustrate the seriousness of the consequences of a mistaken choice of a protected third party.

a. A Failure to Protect Innocent Third Parties to Bills of Exchange

In an unreported 1965 decision of a Costa Rican lower court,[37] it appeared that a drawer of a bill of exchange inserted the name of a well known owner of a coffee plantation as the drawee without the latter's knowledge. The drawer drew the bill of exchange at sight against the drawee and gave it to a payee to whom he owed the amount stated in the bill. The creditor-payee presented the bill to the named drawee and asked him to pay. The drawee refused and stated that he did not know the drawer or the payee, had not signed the bill, and owed no obligation to either of them. The payee sued the drawee in a summary action.

The judge of this unreported decision based his decision upon a legal theory that characterized the rights incorporated into a negotiable instrument as "abstract," "autonomous," or independent of the underlying transaction, thus qualifying the payee of the draft as a protected third party entitled to a summary judgment. He

[36] The National Law Center for Inter-American Free Trade is currently conducting a feasibility study for the securitization, in the U.S. secondary markets, *available at* http://www.natlaw.com/projects/securitization.htm.

[37] *See* Boris Kozolchyk, Jurisprudencia Mercantil, Separata Revista de Ciencias Juridicas, Universidad de Costa Rica. In January 1968, while preparing summaries of all the reported commercial court decisions by Costa Rican courts from 1900-1966, Lic. Rodrigo Oreamuno of the San Jose Bar and one of the Costa Rican researchers alerted this author to a decision by a lower court in the city of Cartago dated October 10, 1966 which had worried commercial lawyers in San Jose. A few days later this author visited with the judge and clerk responsible for this decision. The description of facts and reasoning that appears in the principal text is part of the notes taken by this author during these interviews. These notes are available at www.natlaw.com (an electronic archive of the National Law Center for Inter American Trade, "significant comparative commercial law cases and comments").

added that it was enough "that a name appeared on the drawee-acceptor's column of an instrument for a presumption of liability to arise on it." Even though this decision was not published, its holding quickly spread throughout San Jose, Costa Rica's commercial center. In effect, the holding protected a payee who did not qualify even as a third party, let alone one entitled to protection. It also deprived of protection a totally innocent stranger to any previous real or fictitious credit relationships. Its effects upon the circulation of bills of exchange in Costa Rica were immediate and drastic. At least during the two years during which this author lived in San Jose, many a *bona fide* San Jose merchant refused to have anything to do with bills of exchange.

During this author's conversation with the judicial clerk who helped draft the decision, it became clear that he had not established the facts of the transaction in question and was unaware of the commercial practices related to the use of bills of exchange in San Jose and elsewhere. He had also misunderstood the meaning of the theory of "incorporation of abstract rights" when drafting the ruling. When this author asked this clerk why the decision had imposed liability, or at least a presumption of it, upon a third party who had not dealt with the drawer and payee of the instrument and who had neither signed nor signified his acceptance of liability, his reply was that such a person could always raise these defenses when he appeared in the lawsuit.[38]

Upon further questioning, the clerk admitted that he had not taken into account the cost and aggravation of having to appear and defend a totally unexpected and undeserved action. He also admitted that other than for the case in question, neither he nor the judge had ever seen an actual bill of exchange. He added, however, that he did not see why a three-party instrument such as the bill of exchange was needed when two-party instruments such as promissory notes could do the same job. Since the ruling embodied an incoherent and dysfunctional allocation of the business and legal risks involved in the use of bills of exchange, these instruments and the credit associated with them (such as payments or collections against "documentary drafts") remained rare in the Costa Rican marketplace for several years.

b. A Failure to Protect Good-Faith Holders of Cotton Railroad Bills.

In its 1889 decision of *Friedlander v. Texas & Pacific Railway Co.*,[39] the Supreme Court of the United States failed to select the proper party entitled to third-party protection at a time in which the United States export market of cotton was in dire need of such a protection. The plaintiff was an innocent purchaser-holder of a cotton rail bill which on its face stated that a certain number of bales of cotton had

[38] *Id.*

[39] 130 U.S. 416 (1889).

been shipped on a railroad car. The defendant was a railroad carrier whose agent, without the carrier's knowledge, had issued a rail bill on behalf of the defendant, but without actually receiving a single bale of cotton from the purported shipper.

The Supreme Court of the United States decided to protect the carrier and held that his agent had acted *ultra vires* and, accordingly, did not bind his principal. This rejection of third-party protection to the holders of rail bills, including the banks that financed the cotton trade of the United States with the rest of the world, proved a serious, albeit short-lived, blow to that industry and also an unsuccessful formula for the allocation of the risk of fraud. United States cotton exporters and their bankers, the former threatened with losing their financing and the latter with losing their business, had to mount a costly campaign to compel the United States railroad carriers to accept contractual responsibility for the bills issued by their agents.[40]

The possibility of fraudulent shipments allowed by this decision was such that the Liverpool Cotton Bill of Lading Conference of 1911 had to be convened. As a result of this conference, uniform state law and federal statutory law were enacted to reverse the United States Supreme Court decision.[41] Had this decision not been reversed, United States exporters of cotton would have lost their competitive edge in the world cotton market.

Furthermore, it was only after this legislative reversal that the judicial allocation of legal and business risks among producers, exporters, importers, bankers, carriers of cotton and their insurers was worked out.[42] It placed the liability of the ocean carrier for the proper care in the loading and stowage of the cargo and equipping the vessel, but not for its errors in the management and navigation of the vessel, at the center of the "liability map." Once the scope and extent of the carrier liability was established, it was easier to get the insurance industry to create policies for the liability that arose from the losses that occurred during the other components of the "map," i.e., the earlier and subsequent phases of the shipment sequence.

c. A Failure to Protect Purchasers of Real Property and Holders of Security Interests in that Property

A group of decisions by the Supreme Court of Mexico illustrates an unjustified denial of protection to third-party purchasers or mortgagees of real property. This court relied on a legal principle that required the showing of an uninterrupted chain of conveyances of title in favor of a third party for this party to be

[40] *See generally*, ARNOLD W. KNAUTH, THE AMERICAN LAW OF OCEAN BILLS OF LADING 124 (4th ed. 1953); *see also* Boris Kozolchyk, *Evolution and Present State of the Ocean Bill of Lading from a Banking Law Perspective*, 21(2) J. MAR. L. & COM. 161, 173 (1992).

[41] See the Uniform Bills of Lading Act 4 Uniform Laws Annotated 3 (1922) and the Pomerene Acts, 49 U.S.C. app §§ 81-124 (1988).

[42] *See* Kozolchyk, *Evolution, supra* note 40, at 161, 182-84.

protected under Mexican law against other parties' adverse claims.[43] In other words, each recording had to appear warranted by the preceding one.

Thus, when a recorded title was attacked in an adversary action, the Supreme Court required that the "third party seeking the protection of the land registry must be able to prove not only that he acquired from someone empowered to transfer according to the registry, but also that all previous transferors in the chain were equally empowered."[44] This requirement was described by an appellant in another decision as "diabolical,"[45] and indeed, in that earlier decision, the same court had rejected this requirement.[46] Nevertheless, subsequent decisions reinstated the "diabolical" proof of title by setting forth the following formula of third-party protection: 1) in order to qualify as a third party, such a party has to act in good faith; 2) good faith requires a diligent search; and 3) a diligent search must show an uninterrupted sequence of transactions among a continuity of grantors, presumably, as suggested by a 1959 decision, all the way back to the estate's first recording.[47]

And although a 1966 decision alludes to a ten-year search as possibly sufficient to satisfy the requirement of an exhaustively diligent search,[48] the same decision held: "It is not enough for a purchaser to ascertain that the property was registered in the name of his grantor. He must examine all the registry records and if there is no continuity in the chain of title . . . he cannot prevail over parties who can show such a sequence."[49]

The Supreme Court's view of the ease with which the above searches could be accomplished should have been surprising to even a casual searcher in many of Mexico's land registries. As stated in its 1959 decision discussed earlier: "The registry is so arranged that any person can trace the history of any immovable property, including changes in the status of title and the divisions of the land, as well as the creation of new mortgages and other liens."[50]

Yet, even to this day, searchers in Mexican land registries find it difficult to reliably trace back a chain of title to its first recording, particularly where the land has been subdivided repeatedly and where there have been numerous recordings. Under these circumstances, one must wonder, who was the third party whose diligence was envisaged by the Supreme Court? Surely it could not have been the diligence of "any person." More likely, then, the diligence referred to by the Supreme Court was that

[43] *See* Boris Kozolchyk, *The Mexican Land Registry, A Critical Evaluation*, 12 ARIZ. L.REV.265, 336-38 (1970) [hereinafter Kozolchyk, *Mexican Land Registry*] (for a discussion of these decisions and their reasoning).

[44] *Id*.

[45] *Id.* at 336.

[46] *Id*.

[47] *Id*.

[48] Eufrasia Rodriguez de Ibarra, A.D. 8042/63, March 28, 1966, 105 Semanario Vth.51 (1966); Kozolchyk, *Mexican Land Registry, supra* note 43, at 353-55.

[49] Kozolchyk, *supra* note 43, at 354-355.

[50] *Id*. at 349. Diaz Rivera Dionisio. A.D.6024/58, July 23, 1959, 25 Semanario 6th 266 (1959).

of an expert in the law and practice of the land registry in question. If so, would most purchasers or secured creditors qualify for the Supreme Court's formula of protection? The response must be that, in all likelihood, they would not. This uncertain protection of third-party secured creditors is one of the difficulties involved in financing low- and middle-income housing in Mexico.

d. The Importance of Appropriate Remedies

Certain remedies against legal uncertainty are morally unacceptable as well as economically ineffective. Consider, for example, the Costa Rican "remedy" of imprisonment of debtors, in force approximately a generation ago, whose purpose was to bring about certainty to its commercial and consumer credit market.[51] The reasoning behind this remedy was callous but straightforward: if many debtors ordinarily default on their credit obligations and most of them fear imprisonment, why not legislate the defaulting debtors' imprisonment? Thus, the Costa Rican legislature authorized an action that resulted in debtors' imprisonment for a period of two months to two years unless they complied with a court order to pay the debt or return the collateral.

Contrary to the belief among legislators and judges that if this remedy were deemed unconstitutional Costa Rica's credit system would collapse,[52] no collapse occurred even though the sanction was rarely enforced. In fact, creditors continued to extend credit, albeit at ever increasing rates of interest, despite its non-enforcement and eventual judicial abrogation. And when a researcher asked one of the bailiffs who roamed the city of San Jose looking for defaulting debtors why he reported that no debtors were found after the most perfunctory of searches, his answer was revealing: if this sanction were enforced, most Costa Ricans, including the politicians who enacted it and the judges in charge of applying it, would all wind up in jail.[53] Eventually, this remedy was declared unconstitutional.[54]

[51] *See* Article 568 of the Costa Rican Commercial Code of 1964 and Articles 1002 and 1003 of the Civil Code of 1888 (now abrogated). *See* Kozolchyk, *Toward a Theory, supra* note 10, at 720, 721-24 (for comments to these provisions).

[52] During a conversation with this author in October 1968, the late Justice Ulises Odio of the Costa Rican Supreme Court expressed his constitutional misgivings but pointed to data indicating that more than 1,000 debtors in the city of San Jose (whose population was then approximately 250,000) were imprisoned for *apremio corporal*. A field study of actual arrests conducted by team members of the Law Reform Project under this author's direction showed that no more than four debtors were actually in jail for this action. The remainder in the Justice's printout were reported by the respective bailiffs as "not found" in their residences or places of business.

[53] Kozolchyk, *Toward a Theory, supra* note 10, at 731 n.183.

[54] Article 113, Ley de Jurisdiccion Constitucional No. 7135 of October 11, 1989 published in the Gazette No. 198 of October 19, 1989 and 212 of Nov. 9, 1989 with corrections. *See* www.poder-judicial.go.cr/salaconstitucional/jc.html.

If, instead of imprisoning debtors, Costa Rica had enacted a secured lending law, it would have given these debtors access to secured, self-liquidating loans. These loans would have allowed the debtors to continue in business and in possession of productive assets that would have, when sold, enabled repayment of their debts. However, the success of such a law (this was the same type of law suggested to Mexico's NAFTA negotiator by this author)[55] would similarly depend upon the choice of the right third parties and of the proper protective remedies.

For example, once Mexico decided to enact an effective secured transactions law and an appropriate registry to provide notice to third-party creditors and *bona fide* purchasers of the pledged assets, it considered a system of filing centered on the description of the collateral rather than on the name of the secured debtor. Had Mexico selected the collateral-based filing system, the third-party protection would have been unaffordable and dysfunctional. Each item of collateral, whether a shirt in the inventory of a department store or an account receivable in the portfolio of a bank or factor, would have had to be laboriously described before it could be recorded. Needless to say, much before the conclusion of the first description similarly laborious and time-consuming descriptions would have to be started in order to record the incoming replacement inventory and accounts receivable, *ad infinitum.*

The advisability of giving the struggling debtor a "second chance" by facilitating his access to inexpensive commercial credit has now been recognized by entities such as the World Bank in connection with the law of insolvency and bankruptcy.[56] One of the lessons to be learned from these efforts is that economic development could also be furthered by a legal system's resort to well conceived *ad misericordiam* remedies.

In sum, as was concluded by a study on the role of law in economic development in Central America in the 1960s,[57] the best remedies to encourage third-party participation in marketplace transactions are those that take into account the best (cost effective and fair) practices. Prominent among these are those that protect the third parties and thereby instill trust in the protective legal institutions.

V. AN ILLUSTRATION OF JUDICIAL THIRD-PARTY PROTECTION; SOME OF JUSTICE BENJAMIN CARDOZO'S DECISIONS

[55] *See supra* Part IV.A.

[56] *See* http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/LAWANDJUSTICE/GILD/0,pagePK:181022~theSitePK:215006,00.html - 56k – (Oct 2, 2005) and GILD - Insolvency Initiative, The ROSC assessments on insolvency are conducted by World Bank staff, supported by experts from other institutions. -

[57] Kozolchyk, *Toward a Theory, supra* note 10, at 740-41.

A. A Brief Introduction to Justice Cardozo

Much has been written on the macro-economic effect of legislative enactments such as the United States Constitution or the Code Napoleon and comparatively little on the contribution to economic development of great commercial law judges. And while decisions by Lord Mansfield, the great eighteenth-century English commercial law judge, continue to be regarded as pillars of present day Anglo-American commercial law (including the protection of third parties especially in the law of negotiable instruments), Mansfield's message is not as universal for the private law of our day as is that of Justice Cardozo. Cardozo's private law decisions, mostly handed down during the first decades of the twentieth century, cover areas as diverse as contracts, torts, commercial paper, letters of credit, and trust law and in terms compatible with the values of the most influential legal systems of the day. The following decisions have been selected because of their positive impact upon the development of a thriving commercial market in the United States.

Professor Andrew Kauffman, in his deservedly praised intellectual biography of Justice Cardozo,[58] introduces the judge and the person as follows:

> Benjamin Nathan Cardozo lived for the law, and the law made him famous. He earned his fame both by his influential judicial opinions and by his lectures and books, which explained the work of judges and defended a creative lawmaking role for them. He enhanced his fame with a memorable literary style and personal courtesy and gentleness that led many to describe him in later life as a saint. Cardozo was no saint . . . for his life included the toughness of his many years as an ambitious lawyer, and his character included such human failings and vanity and prejudice; however, he was a good man with extraordinary talents. He became one of the most distinguished judges in the history of American law . . . . His family, the Cardozos and the Nathans were rooted in New York's old Sephardic Jewish community, and he took pride in the fact that his ancestors had arrived in America before the Revolution. Cardozo's father (also a judge) had disgraced the family, however, when he engaged in conduct that forced his resignation amid charges of judicial corruption . . . . Benjamin Cardozo's achievements would help redeem the family name . . . ."[59]

[58] ANDREW L. KAUFMAN, CARDOZO (Harvard University Press, 1998).

[59] *Id.* at 3.

As a result of what Professor Kaufman describes as "the toughness of his many years as an ambitious lawyer," Justice Cardozo acquired a more than passing acquaintance with business practices and with what he himself referred to as a morality "at a level higher than that trodden by the crowd." A product of a religious and ethnic tradition that emphasized honorable behavior, he knew, perhaps, instinctively, when the law had to rise above the level trodden by the crowd and when justice had to be tempered with mercy or *ad misericordiam.*

Justice Cardozo was keenly aware of the importance of the credit market of the United States, one of the most important engines of its economic development, particularly as of the end of the First World War. As the United States dollar started displacing the English pound sterling as the world's most desirable currency, the United States credit market became one of the most active and organized on the face of the earth. Even a casual observer could not fail to notice the pyramidal structure of this market, described earlier in this writing.

The cement that holds this pyramid together is trust in its institutions. Justice Cardozo was aware not only of the role played by this trust, but also of the honesty and fairness required from adjudicators, especially after having suffered the dishonor of his own father's removal from the bench because of his dishonesty. Thus, honesty and fairness together with uncommon wisdom and eloquence became the hallmarks of his adjudication. It will be instructive of his methodology to follow his decisions as they addressed third-party protection at each ascending level of the credit pyramid.

B. Cardozo's Select Decisions

1. Protection of a Poor Apartment Dweller Against Owner Neglect

A tenant in a New York tenement was injured by a falling ceiling whose state of disrepair was ignored by the landlord. The New York Tenement House Law[60] governed this tenancy and imposed an administrative rather than a civil liability upon the careless owner. In *Altz v Lieberson,*[61] Cardozo noted that, at common law, the landlord had no duty to repair damaged rooms. His duty of repair was limited to those parts of the building which the occupants enjoyed in common. The New York Tenement House Law, however, changed this duty. It required that

[60] NY Consol. Laws, ch. 61 (1922). It defined a tenement house as:

> ". . . any house or building, or portion thereof, which is either rented, leased, let or hired out, to be occupied, or is occupied, in whole or in part, as the home or residence of three families or more living independently of each other, and doing their cooking upon the premises, and includes apartment houses, flat houses and all other houses so occupied."

(Tenement House Law, sec. 2, subd. 1).

[61] Altz v. Leiberson, 134 N.E. 703 (N.Y. 1922).

"[e]very tenement house and all the parts thereof shall be kept in good repair."[62] In Cardozo's words, "The comprehensive sweep of this enactment admits of no exception."[63] He identified the ultimate purpose of the law as this:

> [T]he care of those who are unable to care for themselves. The legislature must have known that unless repairs in the rooms of the poor were made by the landlord, they would not be made by any one . . . . The right to seek redress is not limited to the city or its officers. The right extends to all whom there was a purpose to protect.[64]

Yet before Cardozo allowed tenants of tenement houses to sue civilly those responsible for the disrepair, thereby creating a protected class of third parties, he carefully chiseled the contours of this class. First of all, he made it clear that his decision did not answer whether lessees who subleased the whole buildings to the plaintiff tenants were proper defendants: "Whether 'owner' may mean at times a lessee of the whole building (section 140) is a question not before us."[65] Secondly, he warned that a tenant could not sue the owner without giving him proper notice of the disrepair: "No doubt, before a right of action will accrue in favor of the tenant, there must be notice, actual or constructive, of the defect to be repaired."[66] And finally, the damage itself had to be of a certain type: "No doubt the defect itself must be one that has relation to the maintenance of the building as a tenantable habitation."[67]

Under these circumstances, a marginal participant in the tenancy market was entitled to the treatment expected by a regular market participant and was allowed to sue civilly in his own right. In sum, Cardozo's adjudication was centered first on identifying the purpose and function of the statute – "the care of those who are unable to care for themselves." Having identified the principle that guided the statutory rule, he identified the third party of the marketplace entitled to such care and made sure the scope of the protection became also clear, i.e., those who owed the contractual and extra-contractual duties and the extent of their duties. Thus he applied a general rule narrowly enough to cover the set of facts of the transaction in a manner distinguishable from other (actionable or non-actionable) sets of facts and thereby added predictability to it.

[62] Tenement House Law, *supra* note 60, at § 102.

[63] *Altz*, 134 N.E. at 704-05.

[64] *Id.*

[65] *Id.*

[66] *Id.*

[67] 134 N.E. at 704-05.

2. Protection of a Purchaser of an Automobile Who is not in "Privity" of Contract with its Manufacturer

Cardozo's willingness to sanction departures from the common law had profound consequences for both the law of contracts and of negligence. The private law wrought by common law courts since the twelfth century was deeply influenced by feudal legal relationships. The narrowness of such a law was in sharp contrast with the generality of the law wrought by legislators and academic commentators in civil law countries since roughly the enactment of the French Civil Code at the beginning of the nineteenth century, a time when the values of an emerging French bourgeois society replaced those of feudalism. Thus, Article 1382 of the French Civil Code of 1800 could confidently proclaim, "Any human act which causes damage to another obligates the person through whose fault that damage occurred to make reparation for the damage."[68]

Unlike a French judge applying Article 1382 of the Civil Code, the Anglo-American judge did not have as general a proposition in existing case law. On the contrary, if he was a New York appellate court judge, as Justice Cardozo was at that time, he had to find an answer to the question whether the particular defendant in front of him owed a duty of care to the particular plaintiff under New York contract or tort law. This explains why in the common law system, until relatively recently, the rights and duties of buyers or renters of real property, of principals and agents or masters and servants, of bailors and bailees, of owners and their invitees or trespassers were governed by categories in the form of dichotomies first coined in feudal times – the law of landlords and tenants, masters and servants, bailors and bailees, trespassers and invitees or guests.[69]

This feudal ancestry meant that third parties seeking legal protection until quite recently had to show that they were direct participants in the dichotomous relationships. If not, they were owed no duties and they had no right of action. This was, in effect, the statement of the law as it existed prior to *MacPherson v. Buick*[70] by no less an authority than Thomas Cooley, then Chief Justice of the Supreme Court of Michigan: ". . . a contractor, manufacturer, vendor or furnisher of an article is not liable to third parties who have no contractual relations with him for negligence in the construction, manufacture or sale of such article."[71] And even post-feudal legal relationships, such as those derived from contracts freely entered into between buyers and sellers of personal property, could only be enforced where plaintiffs were "in

[68] *See* VON MEHREN AND GORDLEY, THE CIVIL LAW SYSTEM 575 (1977) (for this translation).

[69] *See* B. Kozolchyk, *Law of the United States in Comparative-Legal Reasoning-Perspective*, *in* I UNITED STATES LAW OF TRADE AND INVESTMENT 1-8 – 1-11 (Boris Kozolchyk & John F. Molloy eds., 2001).

[70] Donald C. MacPherson v. Buick Motor Co., 217 N.Y. 382 (1916).

[71] JOHN LEWIS, 2 COOLEY ON TORTS 1486 (3d ed., 1906) (cited by Bartlett, Ch. J., dissenting, in *MacPherson*, *supra* note 70).

privity of contract" with their defendants. Only exceptionally were third-party beneficiaries allowed to invoke contractual rights derived from contracts entered into by others.

Considered in this light the plight of Donald MacPherson, the buyer of a Buick automobile from an automobile dealer, who was injured when one of the automobile's tires collapsed as a result of defective spokes that were manufactured not by the defendant, but by another manufacturer who was a sub-contractor of the defendant. For centuries, the MacPhersons of this world could not sue Buick or General Motors either in contract or in tort. As framed by Justice Cardozo, the issue before the New York Court of Appeals was "whether the defendant owed a duty of care and vigilance to any one but the immediate purchaser, that is to any one but the dealer."[72] Stated differently, could MacPherson, a third party where Buick's sale to the dealer was concerned, sue Buick alleging that it owed him a duty of care and vigilance when manufacturing the car that injured him even though Buick did not manufacture the tire or the defective wheel?

Cardozo's response in favor of MacPherson as a third party of the marketplace needing protection was, as usual, nuanced but momentous, where party purchasers of industrially manufactured products such as automobiles were concerned.

> If the nature of a finished product placed on the market by a manufacturer to be used without inspection by his customers is such that it is reasonably certain to place life and limb in peril if the product is negligently made, it is then a thing of danger. Its nature gives warning of the consequences to be expected. If to the element of danger there is added knowledge that the thing will be used by persons other than the purchaser, and used without new tests, then, irrespective of contract, the manufacturer of this thing of danger is under a duty to make it carefully . . . .[73]

With this statement, Cardozo bridged the gap between a general duty of diligence toward third parties and the duty only to third parties who could claim being part of the dichotomies inherited by the common law from feudal law. The concept that made this bridging possible was that of foreseeability.

As Cardozo concluded: "We are dealing now with the liability of the manufacturer of the finished product, who puts it on the market to be used without inspection by his customers. If he is negligent, where danger is to be foreseen, a liability will follow . . . ."[74] *MacPherson v. Buick's* duty imposed upon manufacturers to foresee the harm, created a protected class of third parties. And by placing upon manufacturers a duty of inspection of the components they bought from

[72] *Id.* at 385.
[73] *Id.* at 389.
[74] *Id.* at 390-91.

subcontractors, it also created a viable formula for the allocation of the risks of manufacture among the various participants. Please recall that the question Cardozo asked himself was "whether the defendant owed a duty of care and vigilance to any one but the immediate purchaser, that is, to any one but the dealer." His answer was "yes" and the formula thereby treated Mr. MacPherson, the occasional participant in the marketplace, as if he were a Buick dealer for remedial purposes. This formula still reigns, and liability schemes through insurance and otherwise have adjusted to it.

3. Protection of a Borrower-Mortgagor from an Overreaching Mortgagee: Equity *Ad Misericordiam*

Borrowers who obtain a mortgage loan to acquire their business property inhabit a level of the credit pyramid higher than that of the impoverished tenant in the *Altz* decision or perhaps even that of the purchaser of the defective wheel of the Buick automobile in *MacPherson*. Nonetheless, such mortgagors can similarly suffer from the business practices of overreaching creditors. In *Graf v. Hope Building Corporation*,[75] a borrower who obtained a real estate loan secured by a mortgage had his bookkeeper send a quarterly interest payment to his lender-mortgagee. The bookkeeper mistakenly sent a smaller amount than was due, but when she discovered her mistake, she notified the mortgagee and assured him that as soon as the borrower returned from Europe in the next few days, he would issue a new check for the missing amount.

The hopelessly absentminded bookkeeper forgot to mention her mistake to the borrower upon his return. A grace period of twenty days following the day of default was stipulated in the mortgage deed. The very next day after this grace period expired, the mortgagee-creditor brought an action to foreclose on the property. Upon learning of the mistake and the action for foreclosure, the borrower immediately sent the amount due plus interest to the mortgagee, but the latter rejected this payment. His rejection was upheld by the trial court and the Appellate Division.

The majority of the Appellate Court upheld the lower court's decision by finding that the mortgagee had not acted unconscionably and that a court of law, albeit acting in an equitable action, could not compel the mortgagee's generosity. Cardozo dissented and noted that a court of equity will not always enforce a mortgage unmoved by an appeal to compassion ("*ad misericordiam*"). He carefully considered the application of equitable exceptions to mortgage foreclosures and noted that "the development of the jurisdiction of the chancery is lined with historic monuments that point to another course."[76]

He focused on the enforcement of acceleration clauses in mortgages and noted that they did not constitute an exception to the principle of strict compliance by the borrower-mortgagor. In his words:

[75] Oscar L. Graf et al., v. Hope Bldg. Corp., 254 N.Y. 1, 171 N.E. 884 (1930).

[76] 254 N.Y. at 9.

> [T]he rule is well understood, and is fair to borrower and lender in its normal operation. Especially is it fair if there is a period of grace (in this case twenty days) whereby a reasonable leeway is afforded to inadvertence and improvidence. In such circumstances, with one period of grace established by the covenant, only the most appealing equity will justify a court in transcending the allotted period and substituting another . . . .[77]

However, extraordinary conditions may make the strict enforcement of such a clause a "disloyalty to the basic principles for which equity exists."[78] In his view, a court of equity may intervene to prevent the creditor from taking an unconscionable advantage of the letter of his bargain. Yet the determination of an unconscionable advantage depends upon the circumstances. As an insightful observer of the marketplace, Cardozo knew what sets of facts indicated unconscionable behavior:

> It is not unconscionable generally to insist that payment shall be made according to the letter of a contract. It may be unconscionable to insist upon adherence to the letter where the default is limited to a trifling balance, where the failure to pay the balance is the product of mistake, and where the mortgagee indicates by his conduct that he appreciates the mistake and has attempted by silence and inaction to turn it to his own advantage . . . . What he did was almost as suggestive of that purpose as if he had kept out of the way in order to avoid a tender . . . . [79]

Thus, taking into account the nature of the mistake, the mortgagee's conduct, and the lack of harm to the mortgagee, equity had the power to make an exception and protect the third party who had acted in good faith, albeit tardily. Unlike in the *Altz* decision, Cardozo was not trying to enable a class of third parties to rely on an *ad misericordiam* action or defense. He acknowledged the fairness of the strict compliance rule, especially when supplemented by a grace period. However, in his carefully crafted remedy, he sent a warning to overreaching mortgagees that in the presence of certain factors such as the good faith of the borrower's mistake, the relatively small sum involved in the deficiency, the unlikely harm inflicted by the one-day delay and the mortgagee's bad faith, an equitable remedy may be fashioned in favor of the borrower. In doing this, Justice Cardozo adhered to a principle of interpretation that ensures predictability by applying the generality of equity in a manner where various sets of facts could be distinguished and a likely third party could determine if his facts belonged in any of the sets.

[77] *Id.* at 10-11.
[78] *Id.*
[79] *Id.* at 12.

4. Protection of an Investor Who Entrusted his Monies to a Managing Partner: Entrustment and a Punctilio the Most Honorable

In *Meinhard v. Salmon,*[80] the defendant Salmon entered into a lease with the owner of the building housing a hotel for twenty years with an obligation to convert the building into stores and offices. Plaintiff Meinhard, a third party to the lease, invested half of the cost for the reconstruction and in exchange was to receive forty percent of the profits for the first five years of the lease and half of the profits for the remaining fifteen years of the lease. Losses were to be borne equally, but Salmon was to be the sole managing partner of the lease. Near the end of the lease, the owner of the building, who also owned the adjoining land, proposed that Salmon tear down the building and build a larger building on the adjoining properties. Without informing Meinhard of the proposed deal, Salmon created a company to manage the new construction and lease. The new rentals would exceed by almost ten times the original annual receipts.

Meinhard did not find out about this new lease until the old lease had expired. Hence, he sued Salmon alleging that he had been left out of the new venture wrongfully and that were it not for his original investment, the new venture would not have been possible. As a remedy, he claimed a participation in the new venture. On appeal, the Court of Appeals held that Meinhard was entitled to almost one half of the interest in the new lease as long as he also assumed half of the liabilities. Cardozo's opinion stressed the fiduciary nature of Salmon's position and the forthright conduct required by his status as the sole trustee in charge of managing the original venture. As a trustee, he was required to disclose to Meinhard that a new project had been proposed to him by the owner of the building and adjoining land.

In Cardozo's words, such joint venturers "owed one another the duty of the finest loyalty while the enterprise continues."[81] His following statement has become an essential element of the law of trusts and has been cited on numerous occasions by the United States and foreign courts:

> Many forms of conduct permissible in a workaday world for those acting at arm's length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive is then the standard of behavior. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.[82]

[80] Morton H. Meinhard v. Walter J. Salmon, 249 N.Y. 458, 164 N.E. 545 (1928).

[81] *Id.* at 459[2].

[82] *Id.*

This decision created a new standard of third party protection for those who entrust their savings to a joint venturer-fiduciary in charge of managing their investments. It required "an undivided and unselfish loyalty." Professor Kaufman quotes Dean Russell Niles for the proposition that *Meinhard v. Salmon* was the most important modern decision on fiduciary responsibility, "for even though Salmon had not violated the code that formerly existed in the business community . . . the commercial ethics of the nineteenth century would not suffice for the twentieth century."[83]

This author would add that the ethics Cardozo was referring to existed much earlier than in the twentieth century, but they were reserved, as in the case of the biblical money-lending, for far fewer members of the commercial community than they are today. Prior to Cardozo's decision, the standard was reserved for the small "brotherly" communities of bankers' bankers or insurers and their re-insurers or for, among others, the Amsterdam, Antwerp, or New York diamond dealers. Decisions such as *Meinhard* did much to generalize such "brotherly" and "clubby" behavior to third party non-members of those exclusive trading clubs. In this sense, it treated not only regular, but also occasional participants in trustee-managed investments as only the most regular participants would have expected to be treated.

As with other Cardozo opinions, the measurement of the protection extended to third parties was always part of his analysis and was directly related to the degree of entrustment by the third party. Where the entrustment was absolute, as in the case of a minor or incompetent person, the punctilio was invariably required to be the most honorable. For example, in *In Re James' Estate*,[84] another famous Cardozo trust law decision, the property entrusted belonged to a minor and the entrustment consisted in the management of the minor's property. The trustee determined that of all the possible buyers of the minor's property, he had the most need for it and consequently would pay the highest market price. In evaluating this conduct, Cardozo did not reject the acquisition as that of an automatic conflict of interest, as is done by much legislation and case law elsewhere. He was willing to approve the acquisition if the trustee could prove that of all the possible acquisitions, it was the most beneficial for the minor and it was done by the trustee following the same standard of punctilio, the most honorable.

5. Protection of Banks Which Pay for Fraudulent Letter of Credit Documents

[83] KAUFMAN, *supra* note 58, at 241. Professor Kaufman also quotes Judge Posner for the statement that no judge has ever come up with a "better formula" for stating the fiduciary duty.

[84] *In re* James' Estate, 86 N.Y.S.2d 78, 89-90 (1948).

O'Meara v. National Park Bank [85] deals with the third parties that reside at one of the highest levels of the credit pyramid – bankers who purchase or discount bills of exchange drawn on them or on other banks as a result of the issuance of a letter of credit by them or other bankers. In other words, a bank issues a letter of credit promising to pay the amount stipulated to, say, a seller of goods if he presents to the bank the required documents, which commonly includes a negotiable bill of exchange or draft drawn against the issuing or intermediary banks which were authorized by the issuing banks to accept and/or pay such drafts.

By the 1920s, it had been settled law in the most important letter of credit centers of the world that the issuing bank's promise to pay the beneficiary on its letter of credit was independent from the underlying transaction or transactions. This made the beneficiary of the letter of credit a protected third party where the pre-existing transaction between the issuing bank and its customer was concerned. He was similarly protected from the actions or defenses that could have emerged from the preceding sale transactions between his buyer and himself. Thus it was not surprising that the majority of the Court of Appeals held that where the issuing bank promised to pay a certain amount of money on the presentation to it of the documents specified in the letter of credit, its payment was not involved in or connected with the underlying contract between itself and the bank's customer, which in this case was the purchase and sale of newsprint paper.

According to the majority of this court,[86] if the newsprint paper when delivered did not correspond to what had been purchased, either in weight, kind, or quality, then the purchaser had his remedy against the seller for damages. Thus, whether or not the paper was what the purchaser contracted to purchase did not concern the bank and in no way affected its liability. It was under no obligation to ascertain, either by a personal examination or otherwise, whether the paper conformed to the contract between the buyer and seller. The bank was concerned only with the drafts or bills of exchange accompanied by the other documents requested by the letter of credit. If the drafts were accompanied by the proper documents, then the issuing bank was "absolutely bound to make the payment under the letter of credit, irrespective of whether it knew, or had reason to believe, that the paper was not of the tensile strength contracted for."[87]

In his dissent, Cardozo agreed with the majority that no duty was owed from the bank to its customer or applicant for the issuance of the letter of credit which required it to investigate the quality of the merchandise. However, he disagreed with the view that if the bank chose to investigate and discovered that the merchandise tendered was not in truth the merchandise which the documents described, it was bound to pay irrespective of its knowledge. He added:

[85] Maurice O'Meara Co. v. The Nat'l Park Bank of N.Y., 239 N.Y. 386, 146 N.E. 636, 39 A.L.R. 747 (1925).

[86] *Id.*

[87] *Id.*

> [T]his controversy is not one between the bank on the one side and on the other a holder of the drafts who has taken them without notice and for value. The controversy arises between the bank and a seller who has misrepresented the security upon which advances are demanded. Between parties so situated, payment may be resisted if the documents are false.[88]

In addition, he pointed to another important market consideration ignored by judges unacquainted with what was at that time an important component of the collateralization of the letter-of-credit transaction. Banks did indeed issue many a letter of credit on the strength of the intrinsic value of documents of title such as ocean bills of lading. In other words, if their customer was not able or willing to reimburse them or if the amount deposited or prepaid was insufficient to cover the value of the letter of credit, the bank would resort to a sale of the merchandise described by the bill of lading of which it was an endorsee. In Cardozo's words:

> I cannot accept the statement of the majority opinion that the bank was not concerned with any question as to the character of the paper. If that is so, the bales tendered might have been rags instead of paper, and still the bank would have been helpless, though it had knowledge of the truth, if the documents tendered by the seller were sufficient on their face . . . . If the paper was of the quality stated in the defendant's answer, the documents were false.[89]

Because he understood this business practice, he could then draw a distinction between the protected status of a third party without knowledge of the fraud contained in the tendered bill of lading and the non-protected status of a beneficiary who was a party to the fraud. As with the above-discussed decisions, Cardozo protected the party who under the circumstances was most deserving. In doing so, he made it possible to arrive at a risk allocation formula that reinforced trust in the letter-of-credit transaction, a formula that has by now gained acceptance much beyond the State of New York.

VI. CONCLUSIONS

Those interested in bringing about economic development through peaceful democratic and evolutionary means (and there is a serious question if it can be brought about on a sustainable basis otherwise) owe a debt of gratitude to Hernando de Soto for having highlighted the role of law in that process. His writings have attracted an extraordinary degree of highly influential attention to key problems of the

[88] *Id.* at 402.

[89] *Id.*

legal systems of developing nations in a manner that eluded less accessible writers, despite the fact that they toiled in the same field for many years. His de-emphasis of legal culture and disregard of the protection of "the other" are, in this author's opinion, curable shortcomings. The road map of economic development through law suggested in this article is submitted in the hope of correcting these shortcomings. The journey should begin by focusing on a discrete cultural, legal, and economic problem of considerable significance, such as the lack of credit particularly to small- and medium-sized merchants and entrepreneurs.[90] The proposed effort[91] should incorporate those business and legal practices that best reflect the cultural values associated with the availability of credit, at reasonable rates of interest, to small- and medium-sized merchants. The legal data and the principles that will guide such an effort should be carefully studied for their utilization in other projects of similar economic magnitude. And judges, when shaping the appropriate adjudicatory remedies for the emerging new law, would do well to acquaint themselves with the above-discussed decisions by Justice Cardozo.

[90] *See* http://www.natlaw.com/projects/securedtrans.htm; http://www.natlaw.com/projects/securitization.htm (for a description of the secured lending and securitization Latin American projects of the NLCIFT).

[91] *See* Boris Kozolchyk, *Highways and Byways of NAFTA Commercial Law; The Challenge to Develop a Best Practice in North American Trade*, 4 U.S.-MEX. L.J. 1 (1996) (for an illustration of the effort that standardized best practices have upon trade investment in economic development).