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Lan Cao

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INTRODUCTION

The dominant discourse on civil rights in the United States has been a discourse on and critique of political rather than economic institutions,[1] public rather than private lawmaking.[2] To the extent

* Visiting Associate Professor of Law, Duke University School of Law; Associate Professor of Law, Brooklyn Law School. For their comments I thank Professors Charles Clotfelter, Neil Cohen, James Fanto, Bailey Kuklin, Norman Poser, Larry Solan, Anthony Sebok, Spencer Weber Waller, and Steve Winter. I am also especially grateful for the extensive and penetrating criticism I received from Professors Arthur Pinto, Thomas Rowe, Jr., and William Van Alstyne. I'd like to express my appreciation to the participants of the John M. Olin Program in Law and Economics at Georgetown University Law Center for their comments, especially Professors Viet Dinh, Steven Salop, Warren Schwartz, and Jane Stromseth, and the faculty at Duke University School of Law, to whom I presented this Article at a faculty workshop. The Article was supported by a summer research stipend granted by Dean Joan Wexler and Brooklyn Law School.

1 Since *Plessy v. Ferguson*, 163 U.S. 537 (1896), *overruled by* Brown v. Board of Educ., 347 U.S. 483 (1954), in which the Supreme Court held that "separate but equal" facilities did not violate the constitutional requirement of equal protection, the struggle for civil rights has been primarily a struggle to eradicate de jure barriers to political equality under the law.

American legal culture and tradition generally accept "that there is a crucial difference between civil and political rights on the one hand and social and economic rights on the other. The American system guarantees civil and political rights—but it does not guarantee those social and economic rights described in the United Nations' Universal Declaration of Human Rights." Morris B. Abram, *Affirmative Action: Fair Shakers and Social Engineers*, 99 HARV. L. REV. 1312, 1326 (1986).

2 By state or public lawmaking, I mean the process by which centralized law is made, for example, the top-down enactment of statutes or the issuance of regulations and decrees. The source of law is the state. For a discussion of the relationship between the sovereign and society, see H.L.A. HART, THE CONCEPT OF LAW 49–76 (1961); for a discussion of the "habit of obedience" to the sovereign, see 1 JOHN AUSTIN, LECTURES ON JURISPRUDENCE OR THE PHILOSOPHY OF POSITIVE LAW 220–24 (Robert Campbell ed., 5th ed. 1885).

As Weyrauch and Bell noted, "[e]ven if we recognize contracts as a form of private lawmaking, it is assumed that we make formal agreements essentially with delegated state power." Walter Otto Weyrauch & Maureen Anne Bell, *Autonomous Lawmaking: The Case of the "Gypsies"*, 103 YALE L.J. 323, 326 (1993). For example, Hart

that economic issues surface, they have been subsumed under and incorporated into the traditional civil rights model of public law, which has produced two prevailing strands of thought: first, equal treatment or antidiscrimination, that is, treating like people alike,[3] and second, affirmative action, that is, when equal treatment alone is

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explained that "many of the features which puzzle us in the institutions of contract or property are clarified by thinking of the operations of making a contract or transferring property as the exercise of limited legislative powers by individuals." *Id.* at 326 n.4 (citing HART, *supra*, at 94). "According to these notions, the legitimacy of lawmaking depends on the authority of the state, or at least on the degree to which the state tolerates private lawmaking." *Id.* at 326.

Private lawmaking, on the other hand, arises from an array of autonomous institutions, communities, and groups. During the Middle Ages in Europe and prior to the rise of a central authority, private associations had a significant degree of autonomy to make rules and to conduct themselves in accordance with the custom of their associations. See Weyrauch & Bell, *supra*, at 327 n.6, for a discussion of sources that deal with the internal ordering of associations as well as those of "aggregated units that are characterized by little or no commonality of purpose."

The informal lawmaking of medieval private guilds can be seen in its modern version "whenever people join in groups, associations, or institutions to pursue common objectives." *Id.* at 327. Private lawmaking is analogous to the process by which decentralized law is made, through the bottom-up emergence of norms and customs that percolate from a structure of private ordering. *See, e.g.*, Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643 (1996).

For a defense of an evolutionary approach to lawmaking, see FRIEDRICH CHARLES VON SAVIGNY, OF THE VOCATION OF OUR AGE FOR LEGISLATION AND JURISPRUDENCE (Arno Press 1975) (Abraham Hayward trans., London 1831). Savigny attacked a proposal to adopt one unified code of laws for all the German principalities, a proposal arising out of the view that "all law, in its concrete form, is founded upon the express enactments of the supreme power." *Id.* at 20–21. According to Savigny, law "is first developed by custom . . . next by jurisprudence,—everywhere, therefore, by internal silently-operating powers, not by the arbitrary will of a law-giver." *Id.* at 30.

The terms "public" and "private" law have been used more frequently in other contexts and have also carried a variety of other meanings. Because the public/private distinction emerged from the notion that there is a separate and distinct private order, private law was deemed law that protected "pre-political rights. . . . Private law, then, was that part of the legal system protecting the private ordering; public law consisted of government compulsions restricting private freedom." Daniel A. Farber & Philip P. Frickey, *In the Shadow of the Legislature: The Common Law in the Age of the New Public Law*, 89 MICH. L. REV. 875, 886 (1991). Under that definition, property law, tort law, and contract law may be considered examples of private law, and labor law and constitutional law public law. *See id.* at 886–87.

3 *See, e.g.*, 42 U.S.C. §§ 1981–2000h (1994 & Supp. II 1997). Racial discrimination in the following areas are prohibited: denial of equal protection—voting is covered by 42 U.S.C. §§ 1971–74e (1994) (Subch. I); public accommodations (Subch. II); public facilities (Subch. III); public schools (Subch. IV); federally assisted programs (Subch. V); government employment (Subch. VI).

deemed insufficient and the state adopts affirmative action to correct discrimination.[4] Despite these conceptual differences, in both instances the theoretical underpinning of the civil rights movement has been the concept of "equal justice under law,"[5] and hence the emphasis on public rather than private lawmaking, legislation, and litigation—rather than community and norms or "habits, customs, and ethics."[6]

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4 Issued in 1965, Executive Order No. 11,246, 3 C.F.R., 1965 Supp. 167 (1965), *reprinted in* 42 U.S.C. § 2000e app. at 538–41 (1994), required government agencies and private contractors to adopt "affirmative action" and "ensure . . . that employees are treated during employment, without regard to their race, color, religion, sex or national origin."

5 Abram, *supra* note 1, at 1312. For an account of the "equal opportunity" versus "affirmative action" split within the civil rights movement, see Paul Brest, *The Supreme Court, 1975 Term—Foreword: In Defense of the Antidiscrimination Principle*, 90 HARV. L. REV. 1, 2–3 (1976). For a critique of both the "equal opportunity" and "affirmative action" strands as both inadequate and anachronistic to current realities, see Anthony D. Taibi, *Racial Justice in the Age of the Global Economy: Community Empowerment and Global Strategy*, 44 DUKE L.J. 928, 931 (1995) ("[C]ivil rights ideologies, rather than constituting a critique of liberal social relations and institutions, are instead an expression of them.").

6 FRANCIS FUKUYAMA, TRUST 5 (1996). For the purpose of this Article, culture can be defined as "systems of shared ideas, systems of concepts and rules and meanings that underlie and are expressed in the ways that humans live." ROGER M. KEESING, CULTURAL ANTHROPOLOGY: A CONTEMPORARY PERSPECTIVE 518 (2d ed. 1981). Anthropologists have attempted different approaches to defining the essence of culture. *See* FRANK R. VIVELO, CULTURAL ANTHROPOLOGY: A HANDBOOK 10 (1978) (describing multiple definitions of culture). Most agree, however, that culture affects one's values, perceptions, beliefs, and conduct. *See, e.g.*, A.L. KROEBER, ANTHROPOLOGY: CULTURE PATTERNS AND PROCESSES 1 (1948); Stella Ting-Tooney, *Toward a Theory of Conflict and Culture, in* COMMUNICATION, CULTURE AND ORGANIZATIONAL PROCESSES (William B. Gudykunst et al. eds., 1985). Anthropologists have within the last two decades refined their understanding of culture away from a notion of a fixed, static set of beliefs, values, behavior, and institutions and more toward a redefinition of culture as a flexible and evolutionary system, itself a process of persistent contestation over its own internal meanings, produced and reproduced over time, unbounded rather than bounded. *See, e.g.*, JAMES CLIFFORD, THE PREDICAMENT OF CULTURE (1988); GEORGE MARCUS & MICHAEL FISHER, WRITING CULTURE (1986). Culture consists of many evolving and interactive aspects and is not "just the sum of habitual practices." JOHN COMAROFF & JEAN COMAROFF, ETHNOGRAPHY AND THE HISTORICAL IMAGINATION 27 (1992).

As I discuss later, those from a common culture with an intricate network of shared cultural norms and ethical systems are more likely to create with and for each other "moral communities because their shared languages of good and evil give their members a common moral life" and facilitate the creation of trust among members. FUKUYAMA, *supra*, at 36. The existence of a common cultural system in a close-knit ethnically homogeneous community makes it more likely for a community market among community members to be established.

As economic difficulties increase and lower-income communities suffer a disproportionate impact of job losses and other social dislocations,[7] economic issues are becoming increasingly paramount in our national debates.[8] Because access to capital is a crucial factor in the operation of small businesses, which in turn is essential to community economic development, studies have indicated that firms which are able to have their capital requirements met are more likely to survive than firms which have no access to capital.[9] More precisely, debt inputs in particular constitute a significant factor in the increased viability of white-owned businesses.[10]

Where economic disparities have been noted, attempts at rectification have been filtered primarily through the traditional public law methodology of the civil rights model.[11] For example, in response to the claim of credit discrimination, the Equal Credit Opportunity Act[12] (ECOA) was enacted in accordance with the prevailing norms of

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7 *See* NATIONAL URBAN LEAGUE, THE STATE OF BLACK AMERICA (1994).

8 In 1993, white households had a net worth of $45,740, about ten times that of black households, which had a net worth of $4,418, and Hispanic households, with a net worth of $4,656. BUREAU OF THE CENSUS, STATISTIC BRIEF: ASSET OWNERSHIP OF HOUSEHOLDS 1993 (issued November 1995). In 1988, the median net worth for white households was $43,279, and the median net worth for African American households and Hispanic households was $4,169 and $5,524.3, respectively. *See* Gualberto Medina, *Minority Access to Capital*, STANDARD & POOR'S REVIEW OF BANKING AND FINANCIAL SERVICES, May 19, 1993, at 95. In 1989, the median net worth for white households was $58,500 and $4,000 for nonwhite households. *See id.*

Minority-owned firms accounted for 11% of the total number of individual proprietorships, partnerships, and Subchapter S corporations in the United States and 6% of their gross receipts in 1992. *See* 1992 ECONOMIC CENSUS: SURVEY OF MINORITY-OWNED BUSINESS ENTERPRISES at 5; *see also* Thomas S. Mulligan, *Understanding the Riots: Six Months Later*, L.A. TIMES, Nov. 18, 1992, at JJ1. In South Central Los Angeles, a predominantly African American area, only 8,646 South Central residents, or 4.2% of the total working population, identified themselves as self-employed in the 1990 U.S. Census. The self-employment rate countywide was 7.9%. The absence of businesses in the area has resulted in "leakage," that is, residents spending more money outside rather than inside the community. *See id.*

9 *See* Medina, *supra* note 8, at 97.

10 A 1993 study reported that while white applicants were able to obtain between $1.91 and $2.09 in debt capital for every dollar of equity capital provided by the loan applicants, black applicants were able to obtain only $.69 to $.74 in debt capital for the same dollar offered as equity capital. *See id.*

11 There have been some attempts in the civil rights movement, for example, the Reverend Jesse Jackson's Operation Push and Minister Farrakhan's Nation of Islam, to address on a concerted and systematic basis the issue of economic, as opposed to civil, rights.

12 15 U.S.C. §§ 1691–1691f (1994 & Supp. II 1997). See also Regulation B, 12 C.F.R. § 202 (1993), which was issued pursuant to the Equal Credit Opportunity Act.

equal treatment and antidiscrimination to ensure that financial institutions treat like applicants alike, without resort to unacceptable, discriminatory criteria,[13] and that all applicants have an equal opportunity to compete for credit.[14] By contrast, the Community Reinvestment Act (CRA)[15] takes the affirmative action route by directing banks to serve low-income neighborhoods within their areas of operation to ensure actual lending by financial institutions in such communities.

Both the ECOA and the CRA[16] emerge from the traditional civil rights model, which emphasizes public lawmaking as a remedy for discrimination, despite the fact that there may be nonracial, economically motivated reasons as well. The public law model, in other words, presumes that inadequate credit is caused primarily, if not exclusively, by racially discriminatory lending practices and proposes to rectify the problem by transposing the articulation of legal rights, legal remedies, and legal sanctions into the arena of economics. These efforts may be laudable attempts to ensure fair lending, equal access to credit, and in the case of the CRA, affirmative lending and investment in local communities. They constitute, however, only a partial picture because they fail to address the economics of lending in the open market and the high transaction costs that are also responsible, in many cases, for

13 *See* 15 U.S.C. § 1691(a) (1994). The ECOA was originally concerned only with sex and marital status. *See* Equal Credit Opportunity Act, Pub. L. No. 93-495, § 701(a), 88 Stat. 1521, 1521(1974). A 1976 amendment expanded the Act's scope to include race and other characteristics. *See* Equal Credit Opportunity Act Amendments of 1976, Pub. L. No. 94-239, § 701(a), 90 Stat. 251, 251.

14 The ECOA is also designed to achieve a level playing field of information. *See, e.g.*, 12 C.F.R. § 202.9(a) (1993) (requiring creditors to notify credit applicants within 30 days of any action taken pursuant to the credit application and additionally to provide an explanation for a denial of credit).

15 *See* Pub. L. No. 95-128, 91 Stat. 1147 (1977) (codified as amended at 12 U.S.C. §§ 2901–2907 (1994 & Supp. II 1997)).

16 My analysis of the limits faced by public lawmaking is focused more on the CRA than the ECOA. Unlike the CRA, the ECOA's statutory scheme is process-oriented, not result-oriented, and does not involve the state in a substantive inquiry into banking decisions.

The CRA has been criticized as being vague and ambiguous. *See* Michael Klausner, *Market Failure and Community Investment: Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. PA. L. REV. 1561, 1561 (1995). For criticism of the CRA as promoting an outdated "ideology of localism" out of step with the globalization of financial markets, see Jonathan R. Macey & Geoffrey Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 VA. L. REV. 291, 303–12 (1993), and as promoting credit quotas and wealth redistribution, see Peter P. Swire, *Safe Harbors and a Proposal to Improve the Community Reinvestment Act*, 79 VA. L. REV. 349, 351 (1993).

the reluctance of banks to lend to certain borrowers and certain communities.

The lack of sufficient lending to members of lower-income communities has been caused by both discrimination and/or market imperfections. Although there is little doubt that the public law framework is necessary to remedy discriminatory lending caused by racial animus, it has been less effective at correcting economically rational lending behavior caused by *market* forces. Lenders need accurate information about borrowers' creditworthiness before lending. Without an efficient infrastructure to correct the problems posed by information asymmetry between lenders and borrowers and to provide accurate information exchange, the transaction costs banks incur to screen, monitor, and enforce loans are too burdensome to make the transaction economically worthwhile. Neither the ECOA nor the CRA is effective at providing the requisite exchange mechanisms that constitute the preconditions necessary to create a market.

This Article examines how the private law framework of immigrant communities utilizes communal cohesiveness not only to bypass formal barriers in the open market but also to establish a market—what I call a "community market"—by contracting back into a community arrangement where every member contributes a set amount of money into a rotating credit association at set times, until all have had a chance to collect. As I discuss below, a rotating credit association functions only if every member who has already claimed her share does not default by defecting but rather continues to contribute until the final rotation when every member has had a chance to collect.

Part I of this Article briefly explores the role of capital and credit in economic development and discusses efforts in the United States to regulate the formal market for credit, through the public civil rights framework of the ECOA and the CRA. Second, applying Coase's theory of transaction costs[17] to the problem of institutional finance, Part I also examines the information and monitoring costs incurred by

17 *See* Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 390–98 (1937); Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). Coase's Theorem introduces the notion of transaction costs (generally "the costs of effecting a transfer of rights") into economic and legal arrangements and poses the question of how to minimize such costs. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 30 (2d ed. 1977). Coase stated that legal decisions and law have no consequence on economic output, assuming no transaction costs. For example, no matter what the assignment of legal rights to a property is, it will be used by the producer who can most maximize the net income from production (unless transaction costs outweigh potential benefits derived from transacting to reassign the rights) because the initial owner of the right will bargain it away to a more efficient producer in exchange for a share of the income that the more efficient producer can achieve. *See id.*

banks and evaluates the extent to which the traditional rights-based, public law approach of the ECOA and the CRA is an adequate mechanism for altering economically rational lending behavior. I do not claim that laws enacted to regulate the formal market for credit are wholly ineffective or unnecessary or that public law itself is generally irrelevant. Part I serves solely to provide a contrast to my main point in Part III, which illustrates how private law responds to and overcomes market-based barriers that exist in the formal economy.

Part II studies a parallel sector of community contracts that exists in immigrant communities. It provides a conceptual framework to examine the relationship between the open market and the community market and to distinguish the community market from other types of markets, such as informal markets. The community market, as I call it, arises to accommodate and promote certain activities that the open market cannot. In essence, the question is one of market formation: where a market for certain exchanges between lenders and marginal borrowers does not exist in the open market because of high transaction costs, what are the preconditions to the emergence of an alternative, community market that is better equipped to accommodate such exchanges?

Part II also draws on norms of solidarity, community, trust, and other elements central to the communitarian debate and asks how the customary practices of various ethnic communities provide the requisite informational infrastructure, thereby facilitating the emergence of a market where lenders and borrowers can contract for credit. In this respect, the community market formed by a community whose members cannot contract with formal banks on the open market is a market that combines market principles of allocative efficiency with community principles of identity and cohesiveness. As Part II main-

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Because there is always some transaction cost, the question becomes which institutional or legal arrangement best minimizes transaction costs. The questions posed have included the following. First, which governance institution, the state or the market, is more efficient for the optimal allocation of economic resources? Second, given market failures caused by opportunism, asymmetry of information, and other negative externalities, markets are not always more efficient; under certain circumstances, government intervention (antitrust laws, for instance) may be necessary to ensure that markets can indeed function in a way that most closely resembles the classic model. Third, given the fact that both state and market arrangements suffer from transaction costs and cannot create perfect competition, what is the second-best choice—public or private ordering?

Coasian theory of transaction costs has been applied to a variety of institutional settings. In this Article, I focus on one type of private, informal arrangement—rotating credit associations and their ability to overcome transaction costs faced by formal lenders. *See infra* Part III.B.

tains, a community market is about community as well as market and thus illustrates how a community's repository of norms and practices can lay the foundation for exchanges that value both community bonds and wealth maximization.

The Article's central points and arguments are in Part III. Here, I study a host of unorthodox but highly effective arrangements organized by entities outside the mainstream of conventional banking structures, for example, immigrants' rotating savings and credit associations such as the Korean "kye," the Chinese and Vietnamese "hui," the Japanese "tanamoshi," the Cambodian "thong thing," the Mexican "cundina," the Ethiopian "ekub," and West Indian "esusu." Immigrants who have neither the resources nor the credit history demanded by banking institutions in the formal economy rely on community mechanisms by contributing a set amount of money into a lending circle, which rotates as loans among members on the basis of need, lottery, or bid. This community-based financial sector, as Part III argues, maintains its effectiveness through a bottom-up information exchange mechanism that lowers the screening, monitoring, enforcement, and other transaction costs associated with formal institutional lending. Part III looks at how rotating credit associations constitute an instance where communitarian-based norms, which emphasize community as opposed to individual commitments, combine with market behaviors to marshal kinship and ethnic affinities in ways that both preserve their moral and social bases and further transactions that improve economic efficiency.

The central paradox can be stated as follows: how and why can marginal borrowers deemed uncreditworthy by a formal financial sector fully backed by public laws, such as contract and other formal collection procedures, be relied upon to repay loans provided by a community financial sector ungoverned by any public laws? Part III examines how norms, social structure, and the production of "social capital"[18] promote economic exchanges without the state's threat of force or sanction.

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18 Robert Putnam has studied how civic organizations strengthen a society's sense of cooperation, trust, and reciprocity—elements called "social capital"—and how social capital is crucial for the success of certain political and economic institutions. *See* ROBERT D. PUTNAM, MAKING DEMOCRACY WORK: CIVIC TRADITIONS IN MODERN ITALY 167 (1993). Different forms of associations and networks are capable of generating social capital to different degrees. *See* Robert D. Putnam, *Bowling Alone: America's Declining Social Capital*, 6 J. DEMOCRACY 65, 76 (1995); *see also* JAMES S. COLEMAN, FOUNDATIONS OF SOCIAL THEORY 302–07 (1990) ("Social capital . . . is created when the relations among persons change in ways that facilitate action."); *id.* at 304; FUKUYAMA, *supra* note 6, at 26 ("Social capital is a capability that arises from the prevalence of

From the conclusion drawn in this Article that a community ordering of credit associations functions as an alternative to open market transactions by providing exchange mechanisms necessary for the emergence of an alternative market, Part IV moves beyond the "jurisdictional" question[19]—which market, community economy, or open market economy—and addresses the substantive question of how best to promote such wealth-enhancing community norms. Part IV asks how and to what extent public law should define the boundary between the formal, open market sector and the community-based sector. First, Part IV argues that where efficient social norms are produced by private groups, courts faced with adjudicating disputes among group members who ignore the group's "no judicial recourse" norm by initiating suit should either dismiss such cases under what I call a theory of "community nonjusticiability"[20] or, in those limited circumstances where judicial resolution is appropriate, take the case but resolve such community-based disputes by deferring to existing group norms.

This proposal is eminently defensible because of the positive incentive structure that gives rise to and governs rotating credit associations. This incentive structure derives from an aggregation of interests that is particular to rotating credit associations and that also distinguishes it from other alternative credit institutions, such as loan sharks. Borrowers and lenders who transact on the open market or through loan sharks for credit do so as disaggregated entities. By contrast, a rotating credit association functions on the basis of aggregation of interests between borrowers and lenders, precisely because the lender *is* the borrower. As a result, the incentive structure is one that maximizes group and individual welfare while minimizing the possibility of defection and exploitation, as well as other forms of abuse.

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trust in a society or in certain parts of it. It can be embodied in the smallest and most basic social group, the family as well as the largest of all groups, the nation, and in all the other groups in between. Social capital differs from other forms of human capital insofar as it is usually created and transmitted through cultural mechanisms like religion, tradition, or historical habit.").

19 *See* Avery Katz, *Taking Private Ordering Seriously*, 144 U. PA. L. REV. 1745, 1747 (1996) (critiquing the overexpenditure of scholarly resources on the question of jurisdiction—"which institution—court, legislature, or community—is best able to set norms"—and proposing that the question be redirected to "what those norms should be").

20 I thank Professor Viet Dinh for suggesting and coining the term. Community nonjusticiability means judges faced with a case arising out of a rotating credit association dispute would decline to hear the case. *See infra* notes 228–34 and accompanying text.

Second, Part IV studies the linkages that should be promoted between the two sectors and argues that where conventional banking arrangements can be modified to incorporate nonlegal norms and other innovative measures that minimize the costs of lending, such modifications should be encouraged.

Economists have focused primarily on the notion of rational choice as the motivating factor for economic behavior—hence the emphasis on aggregate data such as prices and quantities—and have excluded from systematic consideration an individual's social interactions and psychological motivations, "especially when moral considerations dominate choice."[21] My conclusion, however, is that the notion of the "rational profit maximizer" is itself contextually or culturally situated. While the opportunity to contract for credit in the open market is limited because a rational cost/benefit analysis on the part of lenders would lead to a suboptimal availability of credit for certain borrowers, a different result follows when the parties leave the open market to establish an alternative market—by contracting back into a community market of status-based relationships.

In sum, this Article explores how imperfections in the formal market can be remedied through the establishment of a separate community market that relies on an infrastructure of community information exchange to enable borrowers to contract with lenders with minimal transaction costs. The Article thus addresses issues of market imperfections, alternative market formation, and participation in the social, moral, and civic life of a community. By examining rotating credit associations, the Article studies an instance in which communitarian practice, which values cooperation and commitment, intersects with markets, which value wealth maximization and allocative efficiency. My aim is to study how the claims of community are themselves intertwined with economic efficiency—in other words, how social capital may aid in the creation of economic capital.

I. AN INADEQUATE PUBLIC LAW MODEL

A. *State Regulation of the Formal Market for Credit*

Development economics[22] has recognized, since its inception in the 1950s, that the essential problem for lesser-developed countries

21 Shira B. Lewin, *Economics and Psychology: Lessons for Our Own Day from the Early Twentieth Century*, 34 J. ECON. LIT. 1293, 1293 (1996).

22 The term "development economics" originated with economic historian Alfred Sauvy. *See* DIANA HUNT, ECONOMIC THEORIES OF DEVELOPMENT: AN ANALYSIS OF COMPETING PARADIGMS 80 n.1 (1989). It was established as a subdiscipline of economics

lies in the vicious cycle of poverty caused by a scarcity of capital and an inadequate level of savings, which generates a continuing scarcity of capital and conversely, a continued inability to save and invest.[23] Low wages, caused partially by a large pool of surplus and unskilled labor in the oversized agrarian sector, impede savings, which in turn impede capital formation, accumulation, and investment.[24]

A similar problem exists in the economically undeveloped urban areas of the United States. Those who are poor do not make enough to save and thus cannot invest in asset accumulation or other economically productive activities. Hence the quintessential problem: how to achieve a surplus of capital for those who have no surplus or, where savings are low, how to induce capital markets to extend credit to those who have no capital or asset base.[25] Setting aside the issue of discrimination, the high risks which banks may incur due to the absence of capital-and-asset collateral alone can result in patterns of suboptimal lending referred to by some economists as "rational redlining."[26] The essential dilemma can be characterized in the follow-

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and was designed to address the condition of economic undevelopment of the lesser developed nations. *See id.* at 7.

23 *See, e.g.*, RAGNAR NURKSE, PROBLEMS OF CAPITAL FORMATION IN UNDERDEVELOPED COUNTRIES 57 (1953).

24 *See* W. Arthur Lewis, *Economic Development with Unlimited Supplies of Labour, in* PARADIGMS IN ECONOMIC DEVELOPMENT 59, 72 (Rajani Kanth ed., 1994) ("The central problem in the theory of economic development is to understand the process by which a community which was previously saving and investing 4 or 5 percent of its national income or less, converts itself into an economy where voluntary saving is running at about 12 to 15 percent of national income or more.").

25 *See* Edward L. Hudgins, *Why the World Bank Should Read Its Own Report*, HERITAGE FOUNDATION REPORTS, Sept. 22, 1989, No. 727. ("The existence of savings and credit allows households to enjoy the immediate buyouts of various goods and services by borrowing against future earnings. For businesses, credit is crucial. Short-term credit is essential for merchants to keep inventories at levels to keep customer demand. Longer term credit is important not only for establishing productive enterprises but also for expansion, purchases of new equipment and machinery, research and development of new products, and modernization of the production process for maximum efficiency.").

26 The term "redlining" originates from the practice of demarcating certain suspect neighborhoods by the drawing of a red line and refusing to extend loans to those located within the redlined zones.

"Rational redlining" may be caused by high transaction costs involved in identifying and monitoring certain types of loans which may result in a lender's decision to exclude certain areas. By contrast, "irrational redlining" refers to redlining resulting from racial and ethnic discrimination. *See* JACK M. GUTTENTAG & SUSAN M. WACHTER, REDLINING AND PUBLIC POLICY 13–14 (1980). Even if banks could identify low-risk from high-risk borrowers who are either uncreditworthy or who lack collateral, the theory of "rational redlining" suggests that "banks may rationally decline to lend in

ing manner: because those who are poor cannot save enough to accumulate assets, they have too little to qualify for credit. Given the prevailing standards of conventional banking practices, even in the absence of lending discrimination, those who need money the most are those who can borrow the least.

Since the 1970s and in recent years, especially since the disturbances in 1992 in South Central Los Angeles, the availability of credit has become an issue linked with the economic viability of lower-income communities in the United States.[27] Hence, a host of legislative actions has been pursued to regulate the market for credit and to address the concern that the financial industry is engaged in individual credit discrimination as well as community or geographic redlining.[28] In accordance with the equal opportunity, antidiscrimination norms of the civil rights era, the ECOA was enacted in 1974 to ensure nondiscrimination, for example, by prohibiting lenders from requesting, and presumably acting on, improper information concerning certain characteristics of an applicant in either the application or the evaluation process.

A different strategy was pursued with the passage of the CRA in 1977. Departing from the equality of opportunity, procedural fairness, and antidiscrimination norms typified by the ECOA, the CRA, passed as Title VIII of the Housing and Urban Development Act of 1977, was enacted in accordance with the outcome-oriented norms of affirmative action. The prevailing concern behind the CRA is not credit discrimination against individual applicants but rather geographic redlining and disinvestment.[29] Under the CRA, the state adopts remedial action to reverse neighborhood disinvestment by imposing on insured depository institutions the "continuing and *affirmative obligation* to help meet the credit needs of the local communities in which [they are] chartered,"[30] which includes "low-and moderate-income neighborhoods, consistent with the safe and sound operations of such institution[s]."[31]

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low-income neighborhoods, where the costs to a bank of acquiring credit-related information may well be high and the benefit low." Klausner, *supra* note 16, at 1567–68; *see also* GUTTENTAG & WACHTER, *supra*, at 7–12.

27 *See Current Status of the Community Reinvestment Act: Hearing Before the Subcomm. on Hous. and Urban Affairs of the Senate Comm. on Banking, Hous., and Urban Affairs*, 102d Cong. 1–2 (1992) (statement of Sen. Alan Cranston, Chairman, Subcomm. on Hous. and Urban Affairs).

28 *See supra* notes 12–15 and accompanying text.

29 *See generally* Macey & Miller, *supra* note 16, at 298.

30 12 U.S.C. § 2901(a)(3) (1994).

31 12 U.S.C. § 2903(a)(1) (emphasis added).

Yet as I discuss in the second part of this Section, the underlying difficulty lies ultimately with a basic dilemma that is essentially unrectifiable by civil rights regulations. Where the market for credit is marred by market imperfections, law that fails to address the underlying *economic* reasons that cause suboptimal lending will be only partially effective at altering the lending behaviors of financial institutions at issue. The high transaction costs banks must incur to identify sound borrowers among a pool of marginal borrowers have resulted in the absence of a market for such exchanges among lenders and borrowers. Neither the ECOA nor the CRA can create a market when lenders acting pursuant to a rational cost-benefit analysis believe it to be nonviable.

B. Market Imperfections and Transaction Costs

Given the absence of a ready market for loans between particular borrowers and lenders, both the ECOA and the CRA, designed to prod banks into lending when they otherwise would not, can be viewed essentially as efforts to put into place a market for seemingly questionable and marginally profitable loans. The CRA, in particular, pushes banks to reinvest in local communities and extend credit to borrowers under circumstances that may be directly antithetical to fundamental *economic* norms, which may or may not be discrimina-

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Federal bank regulations monitor CRA by assigning each bank a CRA rating of either "outstanding," "satisfactory," "needs to improve," or "substantial compliance." 12 U.S.C. § 2906(b)(2) (1994). A bank that fails in its obligation to meet "the credit needs of its entire community," § 2903(a)(1) (1994), would be faced with a low CRA rating. Federal regulators would then be required to take these ratings into consideration when a bank or its holding company applies to acquire deposit facilities, which may result in delay or outright denial of acquisition, merger, branching, or relocation requests. *See* §§ 2902–03. In 1989, pursuant to the Financial Reform, Recovery, and Enforcement Act of 1989, § 1212, Pub. L. No. 101–73, 103 Stat. 183, 527 (codified as amended at 12 U.S.C. §§ 2902, 2906 (1994)), amendments to the CRA mandated public disclosure of and public access to government CRA evaluations, including data on loans that was either denied or withdrawn. *See* 12 U.S.C. § 2906.

New regulations emphasize result rather than process, *see* Community Reinvestment Act Regulations, 60 Fed. Reg. 22,156 (1995), and focus on an actual lending test (as opposed to the bank's efforts alone) designed to measure the volume as well as dispersion of a bank's lending activity in low-income neighborhoods in its area of operation. *See* 12 C.F.R. § 228.22(a) (1998) (stating that the lending test "evaluates a bank's record of helping to meet the credit needs of its assessment areas through its lending activities").

tory. "[T]he CRA aims to alter a general pattern in the allocation of credit that does not depend on the presence of discrimination."[32]

Indeed, "The objectionable pattern [of suboptimal lending] could be observed in a market in which there is no discrimination."[33] A similar pattern of lending and outward credit flow characterizes the behavior of minority-owned banks as well. In 1992, for example, two of the five largest black-owned banks in Chicago received low CRA ratings of "needs to improve."[34] While there are reports that the CRA has resulted in a sharp increase in lending by banks in inner-city areas,[35] many critics charge that much of this lending has been based on below-market rates and less stringent lending standards, which has caused some to worry that the default rates for such loans will be relatively high.[36] Some, on the other hand, worry that the CRA is not tough enough and should be revised along yet more radical lines, for example, "establishing statutory criteria for CRA-approved investments and . . . mandating that a set percentage of the assets or lending activity of all financial intermediaries be placed in such investments,"[37] or "through direct subsidies to existing banks and through community group assistance with prescreening, technical support, and character determination."[38]

These proposals attempt to circumvent the undeniably high transaction costs that conventional financial institutions face when searching for or responding to lending and investment opportunities in low-income communities. But if the current market-based framework of conventional banking practices continues to prevail, transaction costs banks face when they make certain types of loans must be addressed.

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32 Keith N. Hylton & Vincent D. Rougeau, *Lending Discrimination: Economic Theory, Econometric Evidence, and the Community Reinvestment Act*, 85 GEO. L.J. 237, 250, 253 (1996).

33 *See id.* ("Conversely, a market in which discrimination is rampant might fail to generate the pattern that serves as the primary empirical justification for the CRA.").

34 *See id.* at 254 n.75.

35 *See* Dennis Hevesi, *Giving Credit Where Credit Was Denied*, N.Y. TIMES, June 8, 1997, at J1; David Rohde, *Banks Discover the South Bronx*, N.Y. TIMES, Apr. 16, 1997, at B1.

36 *See* Hylton & Rougeau, *supra* note 32, at 245 n.46.

37 Anthony D. Taibi, *Banking, Finance, and Community Economic Empowerment: Structural Economic Theory, Procedural Civil Rights, and Substantive Racial Justice*, 107 HARV. L. REV. 1465, 1507 (1994); *see also id.* at 1507–08.

38 *Id.* at 1509; *see also* Hylton & Rougeau, *supra* note 32, at 282 ("A subsidy approach would not eliminate administrative costs. However, it would make them a matter of choice for lending institutions.").

Banks typically rely on a number of lending criteria to assess the costs and the benefits associated with making a particular loan, including an applicant's "creditworthiness" and other traditional requirements, such as evidence of continuous employment history.[39] The cost-benefit analysis requires the bank to engage in the process of acquiring accurate information about the applicant, the purpose of the loan, and the location of the project which the loan is expected to support.

One of the imbalances in a credit relationship is the informational asymmetry that inherently exists between the borrower and the lender: the borrower usually has more accurate information about the borrower's own creditworthiness than does the lender.[40] In other words, even though there may be "honest" and "dishonest" borrowers,[41] lenders do not always have adequate information to accurately distinguish one from the other,[42] and further, to determine whether even "honest" borrowers have the necessary resources to repay. To lower their screening costs, banks use techniques to improve their information. They attempt to draw inferences about the creditworthiness of a loan applicant by analyzing information accumulated from similar past loans.[43] Information gleaned from such "observationally distinguishable"[44] groups—in other words, differentiation based on age, occupation, or neighborhood—often leads to a phenomenon referred to as "credit rationing," in which a lender faced with exorbitant

39 These requirements have been criticized as inherently biased because they favor "[w]hite only" borrowers and prevent lower-income applicants who may otherwise be good credit risks from even meeting the threshold standards imposed by financial institutions. *See* Taibi, *supra* note 37, at 1479; *see also* Bob Gnaizda, *Loan Practice Labeled Discriminatory*, SACRAMATENTO OBSERVER, Apr. 29, 1992, at G2.

40 *See* Dwight M. Jaffee & Thomas Russell, *Imperfect Information, Uncertainty, and Credit Rationing*, 90 Q. J. ECON. 651, 664 (1976).

41 *See id.* at 651–52 ("Honest borrowers accept only loan contracts that they expect to repay and under our assumptions, they do in fact repay them. Dishonest individuals, in contrast, default on loans whenever the costs of default are sufficiently low. Lenders, however, are unable to distinguish between the two types of individuals on an a priori basis.").

42 *See* RICHARD A. POSNER, THE ECONOMICS OF JUSTICE 362 (1981) ("In recent times . . . the most important factor responsible for discrimination probably has been information costs.").

43 In the case of home mortgages, for example, to lower the costs of gathering information, banks may rely on information already in their possession regarding prior appraisals of comparable houses. If a certain neighborhood has not had home sales in recent years, and the market value of comparable houses is not available, the information costs for lending will increase.

44 Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, AM. ECON. REV., June 1981, at 393, 406.

investigative costs excludes certain groups of borrowers from its threshold analysis.[45]

Once lenders engage in credit rationing, the economics of their cost-benefit analysis may produce the following result. Lenders may decide that certain categories or subcategories of loan applicants, based on lenders' prior experiences with similarly situated applicants, would be a credit risk, and thus applicants from such categories or subcategories would simply not be given serious, if any, consideration. The alternative, charging a high interest rate to compensate for the high possibility of default,[46] could result in "adverse selection," that is, attracting bad borrowers.[47] Banks would then prefer to offer a lower rate and to ration credit instead, resulting in reduced lending and eventual deterioration in the economic development of certain lower-income neighborhoods.[48]

Besides information costs, banks also face other types of transaction costs—for example, monitoring costs that are incurred in all, but certainly in marginal, loan transactions. The presence of security behind a debt "enhances the lender's ability to enforce payment. . . . If the lender believes when it makes the loan that these advantages increase the likelihood of repayment, the lender can charge less for the

45 *See* Anjan V. Thakor & Richard Callaway, *Costly Information Production Equilibria in the Bank Credit Market with Applications to Credit Rationing*, 18 J. FIN. & QUANTITATIVE ANALYSIS 229, 245 (1983) ("defining credit rationing" as a process in which certain types of loan applications are rejected without serious consideration). *See generally* DWIGHT M. JAFFEE, CREDIT RATIONING AND THE COMMERCIAL LOAN MARKET (1971).

46 *See* Luize E. Zubrow, *Rethinking Article 9 Remedies: Economic and Fiduciary Perspectives*, 42 UCLA L. REV. 445, 541 (1994) ("[N]either an increase in the interest rate or the nonprice terms of the loan (including the collateral provided) is likely to induce the lender to extend credit."); *see also* Stiglitz & Weiss, *supra* note 44, at 395–402 (stating that while charging higher interest rates may increase the likelihood that banks may extend credit to high-risk borrowers, at some point, banks may determine that higher rates will attract a high-risk applicant pool even more likely to default, because borrowers who are likely to default will not be deterred by high interest rates).

47 The term "adverse selection" is used primarily in the insurance context, where it has been noted that "once a firm offers to insure certain risks, parties that are most likely to suffer a loss will be the first to seek insurance." Hylton & Rougeau, *supra* note 32, at 258 n.88.

48 *See generally* Dwight Jaffee & Joseph Stiglitz, *Credit Rationing*, *in* 2 HANDBOOK OF MONETARY ECONOMICS 837, 853–60 (Benjamin M. Friedman & Frank H. Hahn eds., 1990). This assumes, of course, either that banks cannot truly distinguish "honest" and low-risk borrowers from "dishonest" and high-risk borrowers in certain neighborhoods, or that the costs of information needed to make such distinction is too high to make such lending financially worthwhile.

loan, thus lowering the aggregate costs of the transaction."[49] The grant of collateral is especially desirable "for entities that lend to smaller borrowers for whom there is no practical means of monitoring compliance" to the terms of the loan.[50] Thus, creditors may demand security as a way of containing high risks of default,[51] or as a way of lowering monitoring costs.[52] Where security or collateral is unavailable, marginal applicants are likely to be at a disadvantage because the lack of security will mean increased monitoring costs for lenders, resulting in an increased unwillingness to lend.

Thus lenders performing a rational cost-benefit analysis will likely decide against lending to borrowers who lack certain indicia of creditworthiness. The market cannot lower transaction costs that are themselves caused by econmically rational market behavior. Nor can the ECOA or the CRA, because neither is designed to address the cost of lending.

As I demonstrate in Part II, where an imperfect market for certain exchanges cannot be remedied by a public law model, it can be supplemented by what I call a "community market" of rotating credit associations. Embedded within a contextual framework of affinity and shared community norms, rotating credit associations allow members who cannot contract in the open market to rely on the norms of community, lowering the transaction costs of exchanges and building on the community's social capital to create economic capital for its low-income members.

II. THE COMMUNITY MARKET

A. *An Economy of Community: The Market Functionality of Community-Based Lending Circles*

It is generally assumed in market economies that markets, not communities, facilitate economic exchanges. Yet, as I discuss below, community-based associations such as lending circles can help their

49 Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625, 639 (1997).

50 *Id.* at 645.

51 *See, e.g.*, JAMES C. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 536 (3d ed. 1974) (Marginal firms cannot obtain credit on an unsecured basis . . . . In order to make a loan, lenders require security so as to reduce their risk of loss.").

52 It has been suggested that secured financing can be seen as one of the many methods in which creditors cope with the costs of monitoring. *See, e.g.*, Thomas H. Jackson & Anthony T. Kronman, *Secured Financing and Priorities Among Creditors*, 88 YALE L.J. 1143, 1158–61 (1979) (stating that creditors who are inefficient monitors may take security to reduce monitoring burdens).

members overcome market imperfections in the larger society. In other words, certain community norms and behaviors can correct informational asymmetries that are responsible for the high transaction costs in the open market, thereby creating a community market for credit where none could exist before.

Sociologists have noted the historical evolution from community to society.[53] The former is marked by groups bound by ties of kinship, ethnic, religious, or other affinities, and the latter by persons who interact on the basis of utilitarian advantage and whose ties with each other are looser and more contingent than those forged on the basis of community. Familistic relationships and social associations evoke community, or "Gemeinschaft," and open contractual relationships evoke society, or "Gesellschaft."[54] This change from community to society has been characterized as an evolution from feudalism to modernism, from exchanges based on status and "natural will" to those based on contract and "rational will."[55]

When community played a more significant role in its members' lives, "[t]he reciprocal ties of social obligation among members of a community defined standards of behavior."[56] For example, strict codes of conduct were enforced by eleventh-century Jewish traders in the Mediterranean market by the maintenance of close social ties and the use of ostracism[57] as a sanctioning device for behavioral breaches.[58] The movement away from the binding ties of community, however, has allowed people to invoke their freedom of contract to enter "a world of independent actors, each of whom should be allowed to pursue his or her own interests without regard for the interests of others,"[59] limited, of course, by the duty not to inflict harm. Absent public policy and fraud considerations, modern contract law facilitates open market transactions by providing for the enforcement

53 *See* THOMAS BENDER, COMMUNITY AND SOCIAL CHANGE IN AMERICA (1978); ROBERT A. NISBET, THE SOCIOLOGICAL TRADITION (1966); FERDINAND TÖNNIES, COMMUNITY AND SOCIETY [GEMEINSCHAFT UND GESELLSCHAFT] (Charles P. Loomis ed. & trans., 1957).

54 TÖNNIES, *supra* note 53, at 18, 33.

55 HENRY MAINE, ANCIENT LAW 99–100 (J.M. Dent & Sons 1917) (1861).

56 Jay M. Feinman, *Critical Approaches to Contract Law*, 30 UCLA. L. REV. 829, 831 (1983).

57 For a discussion of the possible collision between community ostracism and state law, *see infra* notes 308–24 and accompanying text.

58 *See* Avner Greif, *Reputation and Coalitions in Medieval Trade: Evidence on the Maghribi Traders*, 49 J. ECON. HIST. 857 (1989); *see also* Avner Greif, *Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition*, 83 AM. ECON. REV. 525 (1993).

59 Feinman, *supra* note 56, at 839.

of exchanges[60] that meet the basic requirements of bargain, and in the case of Anglo-American law, consideration.[61] The enforcement of such exchanges is premised on the assumption that the development of an open, transparent market furthers individual freedom of action and at the same time constitutes the most efficient means of allocating resources, resulting in the maximization of wealth and utility for both individuals and society.[62] If markets maximize the wealth of society, they can do so most efficiently because "resources are devoted to their most advantageous use by individuals acting out of self-interest,"[63] or to put it another way, because individuals are allowed the greatest freedom to form their own choices and pursue their own self-interests through arms' length and freely negotiated transactions—without being unduly bound or constrained by the multiple webs of commitments and corresponding burdens exerted by a collectivity of premarket ties.[64]

Once economic exchanges are made pursuant to rational calculations rather than kinship or other personalized relationtionships, the economy can progress into "an increasingly separate, differentiated sphere in modern society."[65] As Adam Smith suggested, perfect competition is conditioned upon social atomization of individuals in their economic interactions.[66] Presumably, the elimination of messy per-

60 The law of contracts provides the means through which one's contract expectations will be enforced. No longer must a contracting party rely on nonstate mechanisms, such as ostracism, gossip, accusations of witchcraft, and other forms of primitive community pressures to produce order. *See* BRONISLAW MALINOWSKI, CUSTOM AND CONFLICT IN A SAVAGE SOCIETY (1926).

61 *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 17, 71 (1981); CHARLES FRIED, CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION 7–14 (1981).

62 *See generally* Richard A. Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEGAL STUD. 103, 132 (1979).

63 Feinman, *supra* note 56, at 840.

64 Indeed, the crisis currently plaguing many Southeast Asian economies may be located in the overemphasis on long-term, familistic-type relationships among businesses and banks, so that "[f]irms were insulated from market forces." *Frozen Miracle, A Survey of East Asian Economies*, THE ECONOMIST, March 7, 1998, at 14. "The long-term relationship between government, banks and firms encouraged cronyism and corruption." *Id.*

65 Mark Granovetter, *Economic Action and Social Structure: The Problem of Embeddedness*, 91 AM. J. SOC., 481, 482 (1985).

66 *See* ADAM SMITH, THE WEALTH OF NATIONS 232–33 (1776) (Andrew Skinner ed., 1979); *see also* 3 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 334 (John Eatwell et al. eds., 1987) (describing the Latin American and Caribbean marketplace and noting that "[a]lthough competition is usually so pronounced that price-rigging is impracticable, the frequency of 'regular customer' relationships means that it is apt to be imperfect").

sonal relations from economic analysis allows transactions to be undertaken primarily on rational and transparent market terms uncomplicated by noneconomic obligations. The existence of personal ties or clannishness may impede entrepreneurship,[67] complicate economic calculations, and present "enhanced opportunity for malfeasance"[68] if one party manipulates the other's trust for fraudulent ends.

If the nonformal, nontransparent nature of economic relationships in less developed countries is deemed abnormal, its emergence and existence in highly developed economies has been viewed as equally, if not more, problematic. This discomfort has been compounded by the fact that many activities not conducted on the open market are often summarily presumed to be informal economy activities—unsavory, parasitic, illegal, exploitative activities.[69] But the informal economy encompasses a wide range of activities. Some activities are conducted outside the view and reach of the formal economy because they are criminal activities, for example, loan sharking or drug dealing. Others "go underground," into the sweatshop industry, for example, because it allows them to evade and defy occupational health and safety standards and child labor or other labor-related laws.[70] There are yet others who favor unrecorded transactions, ranging from informal childcare and housecleaning services to informal street vending, to evade state licensing, taxes, and other costs of participation in the formal economy.[71]

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67 *See* CLIFFORD GEERTZ, PEDDLARS AND PRINCES: SOCIAL CHANGE AND ECONOMIC MODERNIZATION IN TWO INDONESIAN TOWNS 131–32 (1963). Fukuyama has noted that reliance on clannish or familistic networks is helpful for the success of small businesses but detrimental to the formation of large businesses that compete nationally or internationally. FUKUYAMA, *supra* note 6, at 28–29, 62–67.

68 Granovetter, *supra* note 65, at 491.

69 *See, e.g.*, Richard A. Epstein, *The Moral and Practical Dilemmas of an Underground Economy*, 103 YALE L.J. 2157, 2158 (1994); Lora Jo Foo, *The Vulnerable and Exploitable Immigrant Workforce and the Need for Strengthening Worker Protective Legislation*, 103 YALE L.J. 2179 (1994).

70 *See* Jo Foo, *supra* note 69; Christian Zlolniski, *The Informal Economy in an Advanced Industrialized Society: Mexican Immigrant Labor in Silicon Valley*, 103 YALE L.J. 2305, 2321 (1994).

71 *See* Epstein, *supra* note 69; Saskia Sassen, *The Informal Economy: Between New Developments and Old Regulations*," 103 YALE L.J. 2289, 2294 (1994) (arguing that informality is a response to several structural shifts in the economy, such as the high costs of commercial space and other factors of production); *see id.* at 2295 (describing the expansion of high-income consumers who desire customized goods and services that cannot be mass produced but rather must be subcontracted out into the informal economy); *see id.* at 2296–97 (arguing that the expansion of low-income consumers provides a niche for low-cost, low-priced goods and services); Paul Schwartzman, *Van*

For the purpose of this Article, what is important to note is that there is a continuum of economic exchanges. Some exchanges are conducted in the open market, among buyers and sellers or borrowers and lenders who contract with each other on a relatively unfettered, arms' length basis, and who subject their transactions to the reach and scope of laws and regulations ranging from contract and tax laws to safety, labor, and health standards. Other exchanges are hidden in the informal economy, either because they violate the criminal laws or because they seek to evade the state's regulatory or licensing rules. In the latter category, activities such as informal vending have been defended when viewed in reference to the costs and constraints in the formal economy[72] and the concomitant creation of opportunities for certain people, such as "'members of discriminated [sic] ethnic and racial groups [who] tend to be overrepresented as workers in informal enterprises. . . .'"[73] A plausible argument has been made in defense of informal vending in Philadelphia and New York by African-American street vendors who cannot or choose not to comply with the bureaucracy and formality of permits and licenses but who perform a valuable service by providing affordable goods for low-income, African-American consumers.[74]

Ban a Bust, DAILY NEWS, June 9, 1996, at 27 (describing an efficient "shadow transport system" of unlicensed vans competing with inefficient city buses and licensed van owners who had to pay an estimated $7,000 for insurance, permits and plates).

72 *See* Sassen, *supra* note 71 at 2289 ("[T]he 'informal economy' refers to those income-generating activities occurring outside the state's regulatory framework that have analogs within that framework.").

Studies of the formal sector in Peru, for example, have found that where the establishment of a business entailed compliance with a burdensome, bureaucratic, and regulatory system of permits and authorizations, in essence making the conduct of private business in the formal economy not just costly but also unreasonably time-consuming and inefficient, a thriving informal economy has emerged. *See* HERNANDO DE SOTO, THE OTHER PATH 133–46 (1989). De Soto and his group of researchers found that it took eighty-three months to navigate Peru's regulatory maze to obtain a license to build housing on unused state-owned land, ten months to acquire a license costing thirty-two times the monthly minimum wage to start a business, forty-three days to open a retail store, and seventeen years to open a market.

Informal trade by Peruvian street vendors operating without government permits provided employment for an estimated 314,000 people and generated sales of $322.2 million per year. *See id.* at 60. In the same year in which the Peruvian government's investment in public housing equaled $173.6 million, the value of informal housing constructed by informal settlers on unused state land totaled $8.32 billion. *See id.* at 18.

73 George L. Priest, *The Ambiguous Moral Foundations of the Underground Economy*, 103 YALE L.J. 2259, 2273 (1994) (citation omitted).

74 *See* Regina Austin, *"An Honest Living": Street Vendors, Municipal Regulation, and the Black Public Sphere*, 103 YALE L.J. 2119, 2123 (1994) (Informal street vending by

Still other types of activities, however, do not fall neatly into either the formal or informal economies. Seen against this spectrum of economic activities, rotating credit associations can be viewed as a particular instance in which community commitment and cooperation intersect with market-enhancing arrangements in a way that results in the formation of an effective, alternative community economy.[75] Thus, even though rotating credit associations are indeed "informal" arrangements that exist outside the apparatus of the formal market and state law, they are not similar to many typical, informal economy activities, for example, those undertaken to hide from the formal, regulated market. Indeed, a rotating credit association is a community arrangement that allows members to engage in low-cost contracting for credit—not to evade the market or to circumvent the costs of commercial licensing and governmental regulations, but to correct market failures and hence improve the workings of the market.

As I showed in Part I, even without possible race- or class-based discrimination, credit rationing, adverse selection, and other barriers that have kept banks from lending to low-income borrowers are market barriers intrinsic to a market-based, cost-benefit analysis that many rational lenders would make. The absence of a market for such loans is not caused by state-imposed barriers or state regulation but by market imperfections.[76] In fact, in its effort to create a more viable market for such loans, the state has acted—not to *remove* or *loosen* state regulations that may make market entry costly, but to *impose* state laws—for example, the CRA—to circumvent market forces and to prod banks to act in ways that may be contrary to their market-based analyses.

By contrast, an alternative response, and the one I examine, is not one that emphasizes state regulation but one that emphasizes

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African American vendors "employs people . . . [and] supplies blacks with the goods they need and want . . . [and] contributes to the maintenance of black culture.").

Similarly, because public buses and licensed taxi services in New York City, for example, under-serve low-income communities in the more inaccessible outer boroughs, a network of unlicensed gypsy cabs or "livery" car services has also emerged. *See Expensive, But They'll Hack It*, NEWSDAY, May 11, 1996, at A2; Sharon Otterman, *Queens Hails Gypsy Cabs*, NEWSDAY, Sept. 17, 1995, at A56.

75 For an analysis of how rotating credit associations lower transaction costs of screening, monitoring, and enforcement, see *infra* Part III.

76 The reverse is true for some informal economy activities, such as the operation of sweatshops in the garment industry. There, the animating principle is not market enhancing but market avoiding. A sweatshop operator goes underground not because of market barriers but because of state regulation and the costs of compliance with, for example, licensing, tax, and labor requirements.

community market formation. Rotating credit associations, which consist of borrowers who would most likely be considered uncreditworthy by banks, must be seen as the *consumer's* or the *borrower's* solution to *market* imperfections, a consumer-driven arrangement that is a solution to an inherent market deficiency soluble neither by state regulation nor by open market arrangements. In this instance, the constitutive element of a community market, then, is a market-creating, not a market-evading, spirit combined with the reliance on community to improve market efficiency. Rather than muddling economic rationality or furthering unrestrained self-dealings, in some instances community has an efficiency and wealth-producing effect, especially, as I discuss below, if community economic exchanges are governed by norms that encourage cooperation and deter opportunistic behaviors.

B. Norms of Community

Because community contracts are often informal and exist outside the framework of both the formal market and public law, they call into question traditional thinking about markets law in general and economic law in particular, for instance, the relationship between top-down law enacted by the state and decentralized, bottom-up law that emerges from private or community groups. My discussion of community norms in this Section illustrates the extent to which norms can guide the behaviors and expectations of community members, and in this case, provide an ordered framework in which community institutions such as rotating credit associations can regulate member activities without resorting to state law.

Before discussing norms and their capacity to guide social and economic exchanges, I should state at the outset that this is a highly contested area of scholarship. The conception of norms and the emphasis on a nonlegal order as a possible alternative to state regulation have made the debate about the nature and relevance of norms a volatile and political one. As one author has noted, "[T]he rhetoric of 'norms' has served a . . . —dare one say more overtly political?—function. . . . Norms help to assure the conservative or anti-collectivists that the limited laissez-faire approach of an austere common law regime can achieve the proverbial best of both worlds"[77]—decentralized decisionmaking plus order—in which case one might conclude that market failures need not be corrected through legal regulation but possibly through an alternative, nonlaw, norm-based system. Conse-

77 David Charny, *Illusions of a Spontaneous Order: "Norms" in Contractual Relationships*, 144 U. PA. L. REV. 1841, 1844 (1996).

quently, given this considerable degree of controversy,[78] and given my argument that some decentralized community groups such as rotating credit associations are capable of maintaining order precisely because of the influence norms exert on community members in their social and economic exchanges, I will be discussing the concept of norms and its relationship to social order in some detail.

For decades, sociologists have employed the concept of social norms[79] to examine how social meanings are created[80] and how a contextual background of thought, understanding, and expectation influences and shapes individual behavior. Generally speaking, these scholars refer to patterns of informal but repeated and obligatory[81] practices and understandings as norms rather than legal rules,[82] in

78 Robert Ellickson called the claim that norms override law "legal peripheralism" and conversely, the claim that law overrides norms "legal centralism." *See* ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 137–55 (1991).

79 *See, e.g.*, EMILE DURKHEIM, THE ELEMENTARY FORMS OF RELIGIOUS LIFE (Karen E. Fields trans., The Free Press 1995); TALCOTT PARSONS, THE SOCIAL SYSTEM (1912); MAX WEBER, THE PROTESTANT ETHIC AND THE SPIRIT OF CAPITALISM 27 (Talcott Parsons trans., Scribner 1958); Alvin W. Gouldner, *The Norm of Reciprocity: A Preliminary Statement*, 25 AM. SOC. REV. 161 (1960).

80 *See* DAVID I. KERTZER, RITUAL, POLITICS AND POWER 3–4 (1988) ("Human reality is not provided at birth by the physical universe, but rather must be fashioned by individuals out of the culture into which they are born and the experiences they have, experiences that bring them into contact with other people and with various parts of nature."). For other works that study the construction of social meaning, see, for example, PETER L. BERGER & THOMAS LUCKMANN, THE SOCIAL CONSTRUCTION OF REALITY: A TREATISE IN THE SOCIOLOGY OF KNOWLEDGE (1966); ROBERTO MANGABEIRA UNGER, SOCIAL THEORY: ITS SITUATION AND ITS TASK 1 (1987) ("[S]ociety is made and imagined . . . [to be] a human artifact rather than the expression of an underlying natural order."); PIERRE BOURDIEU, SYSTEMS OF EDUCATION AND SYSTEMS OF THOUGHT, *in* READINGS IN THE THEORY OF EDUCATIONAL SYSTEMS 159, 161 (Earl Hopper ed., 1971) (describing certain experiments that powerfully demonstrate the concept of social construction).

81 The fact that a practice is regular and repeated does not alone make it a norm. To qualify as a norm, the practice must also be undertaken with a sense of obligation. "[M]en take off their hats when they enter a furnace room or a church. Taking off your hat to escape the heat is different from taking off your hat to satisfy an obligation. The former is a regularity and the latter is a norm." Cooter, *supra* note 2, at 1656.

82 However, Professor William Jones uses a broader definition of norms. Norms:

> encompass all rules and standards, without regard to their origins or means of enforcement. The legal system provides important norms and usually stipulates sanctions for deviant behavior. But social norms also may be the product of custom and usage, organizational affiliations, consensual undertakings and individual conscience. The essential feature is that norms constrain one person's conduct in deference to the interests of others.

William K. Jones, *A Theory of Social Norms*, 1994 U. ILL. L. REV. 545 (1994).

the sense that norms are nonlegal obligations enforced by something other than legal or governmental sanctions. A norm "tells people more than what they must do, under pain of compulsion; it tells them in a sense what they also 'ought' to do."[83] More recently, economists have also begun to study the origin and function of norms.[84] While neoclassical economics focuses on price or quantity,[85] a developing literature known as "new institutional economics"[86] explores norms

83 GEORGE C. CHRISTIE, LAW, NORMS AND AUTHORITY 2 (1982).

84 *See, e.g.*, GARY S. BECKER, ACCOUNTING FOR TASTES, 225–30 (1996); George A. Akerlof, *A Theory of Social Custom, of Which Unemployment May Be One Consequence*, 94 Q. J. ECON. 749 (1980); Ken Binmore & Larry Samuelson, *An Economist's Perspective on the Evolution of Norms*, 150 J. INST. & THEORETICAL ECON. 45 (1994); Kaushik Basu, The Role of Norms and Law in Economics: An Essay on Political Economy, Paper Presented at the Conference 25 Years: Social Science & Social Change, Institute for Advanced Study, Princeton (May 9–11, 1997).

85 Traditionally, neoclassical theories of exchange had empounded that price considerations outweigh other considerations in economic transactions. *See, e.g.*, Axel Leijonhufvud, *School, Revolution, and Research Programmers in Economic Theory*, *in* METHODS AND APPRAISAL IN ECONOMICS (Spiro J. Latsis ed., 1976), *cited in* JANET TAI LANDA, TRUST, ETHNICITY, AND IDENTITY 6 (1994) ("[T]ransactors interact in markets on the basis of most favorable price and in so doing, ignore relationship of status, kinship, caste, and so on.").

86 *See* Kaushik Basu et al., *The Growth and Decay of Custom: The Role of the New Institutional Economics in Economic History*, 24 EXPLORATIONS IN ECON. HIST. 1 (1987). These economists are now attempting to understand a custom's origin and its persistence. The term "new institutional economics" was originated by Oliver Williamson in a landmark book, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975).

New institutional economics is closely associated with Ronald Coase's concept of transaction cost economics, *see supra* note 17, and is premised on the contention that most economic actors are not isolated individuals but rather members of organizations, groups, or institutions, whose behaviors and motivations are influenced by their social and institutional settings. It emphasizes transaction costs, rather than production costs as used in neoclassical economics, and its focus is on the transaction. Briefly, new institutional economics recognizes that transactions are not cost-free and that economic actors incur extensive costs before and during the performance of the contractual or transactional agreements: information costs about the assets to be sold or bought in the transaction, risk allocation and opportunity costs if the transaction is not completed, monitoring and other precautions to be undertaken in the event other players defect or engage in opportunistic behaviors, and enforcement costs should the other party breach.

Given the existence of transaction costs, the type of institutional arrangements or governance structure entered into and adopted by the parties, given under their circumstances, will play a part in determining the overall cost and benefit associated with the transaction. *See* OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 15–42 (1985). Within this institutional setting, rational decisionmaking and institutional action will also be influenced by how and to what extent the institution is capable of disseminating the necessary information to the relevant actors. *See*

and institutions and their origin and evolution. This new literature explores an area that is often ignored in the neoclassical model. The neoclassical model, which assumes that efficiency derives from perfect competition, also assumes that inefficient institutions will die out because rational individual actors will not favor inefficient choices. Yet some choices are typically beyond the realm of options available to individuals. "[I]ndividuals choose in the marketplace, in shops, in labor markets. They do not choose between institutions, customs and social norms. These evolve in response to a multitude of individual decisions spread over different domains and large stretches of time."[87] Hence the emphasis among institutional economists on the origin and evolution of institutions, customs, and social norms. "Social meanings act to induce actions in accordance with social norms, and thereby impose costs on efforts to transform social norms"[88] because they "bring along with themselves the very mechanisms necessary to preserve their dominance."[89] Thus, norms are often powerful enough to cause people to act, not merely out of habit, but out of a sense of obligation, in accordance with, rather than in contravention of, established norms. Although formal rules structure societal choices and behavior, "the governing structure is overwhelmingly defined by codes of conduct, norms of behavior, and conventions."[90]

Using the works of sociologists and institutional economists who have studied the concept of social norms, legal scholars have also explored the function of norms and the interaction of law and norms, formal and informal rules. From this burgeoning literature, we know that sometimes norms may exert a stronger influence on certain behaviors than legal rules. Robert Ellickson, for example, found that the formal rules that governed different property regimes in Shasta County had little effect on the way neighboring ranchers resolved disputes because the prevailing norms that existed governed their behav-

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DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 22–23 (1990). Additionally, new institutional economics also explores how norms develop and operate within the institution and how various norms—for example, norms of cooperation—influence the institutional environment, the firm's internal structure, and consequently its economic decisionmaking. *See also* WILLIAMSON, *supra*, at 1–8 (discussing the development of the field of new institutional economics).

87 Basu et al., *supra* note 86, at 9.

88 Lawrence Lessig, *The Regulation of Social Meaning*, 62 U. CHI. L. REV. 943, 998 (1995).

89 *Id.* at 999.

90 NORTH, *supra* note 86, at 36. *See generally* EDNA ULLMANN-MARGALIT, THE EMERGENCE OF NORMS (1977).

ior regardless of the legal rule in effect.[91] At other times, legal rules, rather than being more or less peripheral, may have a significant effect on norms, either by furthering or impeding a particular norm.[92]

Norms and their relationship to law have thus been studied and the fruits of study applied to a wide variety of contexts,[93] ranging from dueling[94] and beekeeping[95] to sumo wrestling in Japan.[96] Additionally, as this extensive literature demonstrates, norms may emerge from centralized and organized private agencies, for example, the American grain industry or the Japanese products liability system.[97] The lat-

91 *See* ELLICKSON, *supra* note 78.

92 *See* Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021 (1996) ("Law might attempt to express a judgment about the underlying activity in such a way as to alter social norms. . . . Through time, place, and manner restrictions or flat bans, for example, the law might attempt to portray behavior like smoking, using drugs, or engaging in unsafe sex as a sign of individual weakness."); Richard H. McAdams, *Cooperation and Conflict: The Economics of Group Status Production and Race Discrimination*, 108 HARV. L. REV. 1003, 1065–85 (1995) (discussing how the passage of the Civil Rights Act of 1964 facilitated the erosion of the social norm that kept white business owners from serving or hiring blacks for fear of social stigma, since white business owners who now hire or serve blacks could be doing so because discrimination is illegal).

At the same time, however, while legal rules certainly influence the construction of social reality, their influence is often limited. *See* Pierre Bourdieu, *The Force of Law: Toward a Sociology of the Juridical Field*, 38 HASTINGS L.J. 805, 840 (1987) ("There is no doubt that the law possess a specific efficacy. . . . Nevertheless, this efficacy, defined by its opposition both to pure and simple impotence and to effectiveness based only on naked force, is exercised only to the extent that the law is socially recognized and meets with agreement, even if only tacit and partial. . . .").

93 *See generally* Symposium, *Law, Economics, and Norms*, 144 U. PA. L. REV. 1643 (1996).

94 *See* Lessig, *supra* note 88, at 968–72, 1019–25. Lessig describes how the law banning dueling in the American South failed "in part because it directly challenges the norms of loyalty built within the social structure, and these norms can be quite strong." *Id.* at 971. *See also* Warren F. Schwartz et al., *The Duel: Can These Gentlemen Be Acting Efficiently?*, 13 J. LEGAL STUD. 321, 335 (1984).

95 *See* Steven N. S. Cheung, *The Fable of the Bees: An Economic Investigation*, 16 J.L. & ECON. 11 (1973). Cheung described the informally enforced norm among apple orchard owners regarding beekeeping in rural Washington. Given the fact that bees fly from one orchard to another and pollinate trees on neighboring orchards, it might make sense for each orchard owner to rely in part on bees from other orchards to pollinate trees on his own orchard. However, if everyone were to keep fewer bees than is needed to pollinate his own orchard, relying instead on bees from neighboring orchards, there would be an overall shortage—hence the norm that obligates everyone to keep his proportionate share of bees during the pollination period.

96 *See* Mark D. West, *Legal Rules and Social Norms in Japan's Secret World of Sumo*, 26 J. LEGAL STUD. 165 (1997).

97 It should be noted that nonlegal obligations may be created by centralized or decentralized groups. As David Charny pointed out, the term "norms" has been used

ter constitutes a particular type of "nonlegal governance regime . . . in which the parties devise a fairly comprehensive system that includes written rules of conduct, sanctions, and procedures for enforcement."[98] On the other hand, norms may also emerge from relatively informal private groups, for example, "spontaneously" as a result of interactions among ranchers in rural California or, as is more relevant to this Article, among members of closely knit and ethnically homogeneous groups. Without the state to act as mediator of formal rights and duties, a community-based market depends not on the establishment of a fixed legal rule but on the existence of guiding principles and norms. Repeated interactions over time among members of a community, such as those of rotating credit associations, produce norms and customs that coordinate community behavior and maintain community order without resorting to law.[99]

Repeated, enduring exchanges among groups or networks are also likely to produce a commitment toward norms of reciprocity,

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as much "for comprehensive and relatively complex regimes as for more informal and diffuse sanctioning systems." Charny, *supra* note 77, at 1845. Ellickson's work on ranching norms in Shasta County, California, describe highly informal norms that emerge in a highly informal context outside the framework of any formal or centralized, albeit private, organization. *See* ELLICKSON, *supra* note 78; Robert Ellickson, *Of Coase and Cattle: Dispute Resolution Among Neighbors in Shasta County*, 38 STAN. L. REV. 623 (1986).

By contrast, norms or nonlegal obligations addressed by other scholars are much less informal and much less "spontaneous" because they are obligations produced and enforced by highly ordered private organizations. Norms that govern the diamond bourse, for example, a relatively centralized private organization, are themselves relatively formal ones with written rules. *See* Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992) [hereinafter Bernstein, *Opting Out*]. So are product liability norms that govern Japan's Product Safety Council, termed "strict liability by private ordering," as discussed in J. Mark Ramseyer, *Products Liability Through Private Ordering: Notes on a Japanese Experiment*, 144 U. PA. L. REV. 1823, 1823 (1996). Another example is the set of business norms enforced by the American grain industry, the National Grain and Feed Association, as described in Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765 (1996) [hereinafter Bernstein, *Merchant Law*].

98 Charny, *supra* note 77, at 1841.

99 Custom emerges from community practice and is not "made" by decree, statute, or regulation. H.L.A. Hart noted that because custom evolves from practice and does not contain an established procedure for change or reform, its evolution may be frustrated in certain instances. *See* HART, *supra* note 2, at 90–91 (1961). For a discussion of the concept of norms as not simply regularities or inclinations but rather also obligations, see *infra* notes 106–07 and accompanying text.

high levels of trust, and intragroup cooperation.[100] Enduring relationships, whether in the context of network forms of organization[101] or homogeneous communities with a history of common cultural ties, are more likely to use "voice" and coordination rather than "exit" or "tit for tat" behavior to resolve disputes.[102] In such communities, where members are "repeat players," "[t]here is therefor a constant incentive shared by all parties to get the rule right. But there is only a short-term interest of one party to get it wrong, and even that temptation will not dominate his conduct if his private, long-term losses outweigh these short-term gains."[103] Norms of cooperation which generally promote investment might emerge in the following way. In an "agency game," in which the player who makes the first move—the principal—decides whether to invest or not invest, the player who makes the second move—the agent—has the choice of either cooperating and investing or appropriating and defecting—in other words, stealing the principal's investment.[104] With the agent's possible defection looming in the background, the principal may decide not to invest, causing both parties to lose out on a potentially productive and mutually beneficial transaction. By contrast, if the game is repeated and norms of cooperation are produced or maintained, a different result follows.

> [E]very agent has an incentive to provide signals that induce principals to invest. Every agent will signal "cooperation," regardless of whether his real strategy is cooperation or appropriation. Conse-

100 *See* Mark Granovetter, *Coase Revisited: Business Groups in the Modern Economy*, 4 INDUSTRIAL & CORP. CHANGE 93–131 (1995). In his analysis of business groups, Professor Granovetter argued that one distinctive characteristic of such groups is their "moral community" in which trustworthiness is expected and opportunism deterred. *See also* ROBERT M. AXELROD, THE EVOLUTION OF COOPERATION 12–14 (1984) (using economic analysis of social norms to explain how efficient solutions can be struck when a game is repeated between the same players); MICHAEL TAYLOR, COMMUNITY, ANARCHY AND LIBERTY 65–90 (1982) (arguing that community is necessary for the emergence of a stateless order); ULLMANN-MARGALIT, *supra* note 90, at 76 (describing the types of social interaction in which norms emerge and how norms of small groups or communities make coordination possible); Drew Fudenberg & Eric Maskin, *The Folk Theorem in Repeated Games with Discounting or with Incomplete Information*, 54 ECONOMETRICA 533, 533–36 (1986) (describing inefficient solutions in one-shot games versus efficient solutions in repeated games); Joel M. Podolny & Karen L. Page, Network Forms of Organization (unpublished paper, Graduate School of Business, Stanford University).

101 *See, e.g.*, Podolny & Page, *supra* note 100.

102 *See id.* at 5; Cooter, *supra* note 2, at 1658–59.

103 Richard A. Epstein, *The Path to T.J. Hooper: The Theory and History of Custom in the Law of Tort*, 21 J. LEGAL STUD. 1, 12 (1992).

104 *See* Cooter, *supra* note 2, at 1657–77.

> quently, a consensus will arise in the community about how agents ought to act. Such a consensus will convince some members of the community to internalize the norm and to ingrain it in the young. Thus a new norm will emerge in the community.[105]

According to scholars who have studied the influence of norms, norms can be powerful because they guide behavior, not by reference to external rules, but by invoking an internalized sense of obligation[106] and providing a system of enforcement to ensure against noncompliance. Thus, norms are more than simply established routine, habit, or regularities. In other words, norms "are expectations about action—one's own action, that of others, or both—which express what action is right or what action is wrong."[107] Individuals who have internalized a norm suffer a psychological penalty—guilt or remorse, for instance—if they fail to abide by the norm, whether or not noncompliance would be detected by others.[108] There is also a "psychic/

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105 *Id.* at 1666.

106 *See generally* GEORGE H. VON WRIGHT, NORM AND ACTION: A LOGICAL INQUIRY 70–92 (1963); Cooter, *supra* note 2, at 1656. *See also* BECKER, *supra* note 84, at 225 ("Norms are those common values of a group which influence an individual's behavior through being internalized as preferences."). Psychologists have long studied the internalization of obligations and the influence of social and cultural norms on behavior. *See, e.g.*, JEAN PIAGET, THE MORAL JUDGMENT OF THE CHILD (Marjorie Gabain trans., 1965); Lawrence Kohlberg, *The Philosophy of Moral Development: Moral Stages and the Idea of Justice, in* 1 ESSAYS ON MORAL DEVELOPMENT 1, 409–12 (1981); Lawrence Kohlberg, *Stage and Sequence: The Cognitive-Developmental Approach to Socialization, in* HANDBOOK OF SOCIALIZATION THEORY AND RESEARCH 84, 97–100 (David A. Goslin ed., 1969). For sources on the process of socializing children into internalizing society's cultural norms, see Richard H. McAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338, 380 n.148 (1997).

107 James C. Coleman, *Norms as Social Capital, in* ECONOMIC IMPERIALISM: THE ECONOMIC METHOD APPLIED OUTSIDE THE FIELD OF ECONOMICS 135 (Gerhard Radnitzky & Peter Bernholtz eds., 1987). "A norm may prescribe certain actions such as the norm that an athlete on a team should play his best. Or it may proscribe certain actions, such as the norm among observant Jews and Muslims of not eating pork, or the norm once held among observant Catholics of not eating meat on Friday." *Id.* at 135.

108 *See* Cooter, *supra* note 2, at 1662–63 ("[I]nternalization . . . can tip the individual's motivational balance . . . . From this perspective, internalization attaches a 'guilty penalty' to violating a norm, which can change the sign of the net psychological benefits."); Robert D. Cooter, *Law and Unified Social Theory*, 22 J.L. & SOC'Y. 50 (1995); Robert C. Ellickson, *Bringing Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics*, 65 CHI.-KENT L. REV. 23, 45–46 (1989). For a different conception of the relationship between internalization of norms and compliance of norms—one based not on the psychological cost of guilt or unpleasantness attached to breaching an internalized norm—see THOMAS NAGEL, THE POSSIBILITY OF ALTRUISM 79–89 (1970) (emphasizing an internalized perception of correctness of behavior rather than the desire to avoid guilt).

social"[109] bond that is derived from the members' internalization of community norms, so that one who breaches this bond may experience "'loss of opportunities for important or pleasurable association with others, loss of self-esteem, feelings of guilt, or an unfulfilled desire to think of himself as trustworthy and competent.'"[110]

However, even where a norm exists but has not been internalized by community members because, for example, "the obligation is vaguely defined, what counts as a violation may depend on what others think is a violation,"[111] not necessarily on one's own internalization of the obligation. In this case, when a norm is not internalized in a way that may cause a norm violator to suffer internal psychological costs such as guilt, external but nonlegal enforcement sanctions—and relatively low-cost ones at that—may still exist. "Nonlegal enforcement sytems come in many varieties. The ordinary rules of everyday conduct are enforced by the gossip of neighbors[112] and the scolding of friends; at the other extreme of complexity, investors may comply with intricate financial arrangements mainly to preserve their market reputation, rather than from fear of lawsuit."[113]

In certain communities, especially those that are closely knit, geographically concentrated, and relatively homogeneous, each member has a reputation that is easily known to other members of the community, and this "reputational bond"[114] maximizes both the individual's compliance with established community norms and the community's enforcement of its shared norms against rule breakers. In closely knit communities especially, a member's act will carry social meanings that are of particular significance to other members of the same community. Every act "conveys in its particular context an easily recognized

109 Bernstein, *Opting Out, supra* note 97, at 139.

110 *Id.* (quoting David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 393 (1990)).

111 McAdams, *supra* note 106, at 385.

112 *See* Philip Pettit, *Virtus Normativa: Rational Choice Perspectives*, 100 ETHICS 725 (1990). Enforcement of group norms and sanctioning wrongdoers can be done through gossip. It is assumed under this theory that people are moved by a concern that others not think negatively of them. In this way, it is similar to what has been called the "esteem theory of norms," *see* McAdams, *supra* note 106, at 377, that norms are complied with because noncompliance will result in the withholding of esteem by others. According to Pettit, gossip works to sanction perceived wrongdoers because "people do not have to discipline violators intentionally, going out of their way for example to rebuke them or report them to others; they just have to disapprove of them—whether that attitude ever issues in intentional activity." *Id.* at 739.

113 Charny, *supra* note 77, at 1841.

114 *See* Bernstein, *Opting Out, supra* note 97, at 116.

meaning,"[115] which is itself contingent "on a particular society or group or community within which social meanings occur."[116] Thus, a passenger who buckles her seatbelt in a taxi in Budapest signals "insult" to the driver.[117] A handshake among diamond buyers and sellers in the Orthodox Jewish community may signal "offer and acceptance."[118] Similarly, an oral agreement and a handshake[119] may mean agreement to participate in a community rotating credit association that includes consent to the association's informal rules—that one who has collected her share from the association is obligated to pay the amount back by continuing to deposit her contribution until every other member of the association has had a chance to collect.[120]

If a person acts in a way that is contrary to the community's norms, "[that] action creates a stigma [and] that stigma [has] a social meaning"[121] which may have a negative impact on the violator's reputation. Others in the community may respond by withholding their esteem as a means of externally sanctioning the norm violator,[122] which may result in loss of future business with other members of the business group, reputational injury, ostracism, and banishment from the community.[123] When disputes do arise, they are almost exclusively

115 Lessig, *supra* note 88, at 954.

116 *Id.* at 952.

117 *See id.*

118 *See infra* note 180.

119 Jim Szymanski & Jaymes Song, *Trust is the Key to "Kye" Investment*, TACOMA NEWS TRIB., June 16, 1996, at D1.

120 *See infra* Part III.

121 Lessig, *supra* note 88, at 951.

122 This is what Richard McAdams calls the "esteem theory." *See* McAdams, *supra* note 106, at 377. McAdams examines the "power of esteem sanctions" and discusses what he calls the "feedback effect," in which "[p]eople competing to be 'well thought of' compared to others discover that the cost of their noncompliance—the status loss from deviance—increases as compliance increases." *Id.* at 365–66. For a discussion of the importance of peer disapproval to deterrence, see *id.* at 368 n.114. *See also* Jones, *supra* note 82, at 566–67 ("[T]he individual's concern about her standing among her peers is the means by which the group's norms are enforced. The ultimate sanction for deviance is expulsion, but the simple wish to be well regarded by other members of the group may assure conformity."); Pettit, *supra* note 112, at 739–40 ("[P]eople are moved in great part, though not exclusively, by a concern that others not think badly of them and, if possible, that they think well of them.").

123 *See* McAdams, *supra* note 106, at 380 n.144, for sources cited therein which distinguish, from among nonlegal sanctions, fear of disapproval and internalized norms.

Social norms, however, would not be effective as a means of ordering the behavior of people who prefer defiance to conformity and thrive on incurring social disapprovals by breaching established norms. *See* Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 918 (1996).

resolved by relying on and applying community norms—"an elaborate, internal set of rules, complete with distinctive institutions and sanctions"[124] consisting of trade custom and usage and Jewish law outside the realm of "state-created law."[125]

By contrast, conduct that conforms to the norm of the community or a business sector is more likely to bestow a range of benefits—reputational enhancement, social approval, increased standing in the community—than conduct that does not. Dealers in the primarily Orthodox Jewish diamond industry in New York City, for example, conduct their business without the expense of formal contracts by relying on each others' reputation bonds. Because "the value of an individual's reputation is a function of the degree to which he possesses those attributes that other dealers consider important in business relationships,"[126] reputation has a market value.

At least two factors that I have explored above deserve further emphasis. The ability of private groups to enter into economically efficient and mutually beneficial relations is influenced as much by an institutional setting of common background norms as by the fact that their members interact with each other repeatedly. Where businesses conduct their activities in accordance with an established and systematic panoply of community norms, to the extent that the norms are desirable from a societal perspective, the activities are essentially self-regulated and "frictionless" in the sense that adherence to them does not require the imposition of additional rules to ensure compliance. In the absence of perfect information, the configuration of nonprice mechanisms generated by individual internalization of community norms—the "ought" and the "should," notions of obligation and trust, for example—constitutes one of the key factors that can promote reciprocity and cooperation, facilitate the process of economic exchange, and minimize transaction costs.

Additionally, "Members of a close-knit group develop and maintain norms whose content serves to maximize the aggregate welfare that members obtain in their workaday affairs with one another."[127] In agency language, the emergence and acceptance of a business norm among repeat players will encourage principals to invest if they believe that their agents subscribe to the norm of cooperation rather than appropriation, or that those who appropriate will be subject to community sanctions, which will in turn create an increase in the

124 Bernstein, *Opting Out*, *supra* note 97, at 115.

125 *Id.*

126 *Id.*

127 ELLICKSON, *supra* note 78, at 167.

levels of production and investment.[128] Thus, mutuality of interests and repeat play are important factors that will help tip the scale in favor of cooperation and away from defection, and as I demonstrate below, help explain why the norms that govern rotating credit associations are capable of providing an effective, private ordering of community market outside the realm of state law.

III. ROTATING CREDIT ASSOCIATIONS AND THE LOGIC OF SOCIAL CAPITAL

A. The Mechanics of Rotating Credit Associations

Simply defined, a rotating credit association is "a group who pool their funds on a regular basis then rotate the pool around the group until all members have received it,"[129] essentially functioning as both a savings and lending device. The rotating credit association is known by a variety of ethnic names—the "kye" in the Korean community, the "ekub" in the Ethiopian community, the "esusu" in the West Indies community, the "tanamoshi" in the Japanese community, the "hui" in the Chinese or Vietnamese community, the "thong thing" in the Cambodian community, and the "cundina" in the Mexican community.[130] While businesses have fled inner-city communities in recent years, "a new ethnic mercantile class" has moved in.[131] The economic

128 *See* Cooter, *supra* note 2, at 1666–69.

129 *See* IVAN LIGHT & EDNA BONACICH, IMMIGRANT ENTREPRENEURS: KOREANS IN LOS ANGELES 1965–1982, at 244 (1988); *see also* IVAN H. LIGHT, ETHNIC ENTERPRISE IN AMERICA 23 (1972) (defining a rotating credit association as "'an association formed upon a core of participants who agree to make regular contributions to a fund which is given, in whole or in part, to each contributor in rotation'") (quoting Shirley Ardener, *The Comparative Study of Rotating Credit Associations*, 94 J. OF THE ROYAL ANTHROPOLOGICAL INST. 201, 201 (1964)).

130 *See* Chris Woodyard, *Roadside Revival by the Patels*, L.A. TIMES, July 14, 1995, at A1 (describing Indian businesses and Indian credit associations); Lena H. Sun, *Traditional Money Pools Buoy Immigrants' Hopes*, WASH. POST, Feb. 17, 1995, at A1 (stating that Bolivian associations are called "pasanaqu"); David J. Jefferson, *Neighborhood Financing: Lending Clubs Offer Social Support and Quick Capital to Asian Immigrants*, WALL ST. J., Feb. 24, 1989, at R13 (describing the Chinese "hui," the Japanese "tanomoshi," the Vietnamese "hoi," and the Korean "kye"); John Flinn, *Success the Old-Fashioned Way*, S.F. EXAMINER, April 30, 1995, at D1 (describing the Cambodian "thong thing," used by the Cambodian community to finance Cambodian doughnut shops); Stephen Magagnini, *Tong Ting: Ancient Financing Tactic Finds New Uses*, SACRAMENTO BEE, Oct. 16, 1993, at B1 (describing the Cambodian tong ting and the Mexican cundina, among others); *Jamaican Emigres Bring Thrift Clubs to New York*, N.Y. TIMES, June 19, 1988, at A34. (describing Jamaican and other Carribean credit associations).

131 *See, e.g.*, Pauline Yoshihashi & Sarah Lubman, *American Dreams: How the Byung Kim Family of Los Angeles and Other Koreans Have Made It in the U.S.*, WALL ST. J., June

basis for many of these businesses is often found in the ethnic institutions and resources of the community, and newcomers with no credit history have resorted to the community credit market to finance their businesses.[132]

By participating in a rotating credit association, every member, except the very last member to draw from the pool, can access a lump sum of capital that she would not have been able to access but for the association. For example, assume that a credit pool consists of $50,000 and ten members, each of whom needs $50,000 to start a business, and that each member is able to save $5,000 per year. At that rate, unless a commercial bank loan is available, it would take ten years for each member to accumulate enough capital to start a business. By contrast, it would only take one year for the members together, through a rotating credit association, to raise $50,000 for one loan, resulting in an efficiency gain and a decrease in opportunity costs.

Rotating credit associations have existed in many cultures and originated hundred of years ago to enable members to pool their cash to finance businesses, burials, marriages, and other family and social obligations.[133] The Korean system, for example, dates back to Korean

16, 1992, at A1; Sandra Sugawara & Elizabeth Tucker, *New Firms Backed by Family, Friends*, WASH. POST, Dec. 16, 1987, at A1 (noting that in the Washington D.C. area there are approximately 2,300 Hispanic-owned businesses, 300 owned by Indo-Chinese, 2,000 by Koreans, 500 by Chinese, and 85 to 100 owned by Ethiopians); Matthew Schifrin, *Horatio Alger Kim*, FORBES, Oct. 17, 1988, at 92 (noting that in New York, Koreans own 85% of the retail green-grocery business, and in the poorer sections of Atlanta, Georgia, Washington D.C., Oakland, California, Newark, New Jersey, Harlem, the South Bronx of New York, and the South Side of Chicago, Koreans dominate the inner city green-grocery business); Jefferson, *supra* note 130, at R13 (discussing the role of immigrant credit associations in the revitalization of the Los Angeles metropolitan area by Chinese immigrants, New York City neighborhoods by Koreans, and Westminster, California by Vietnamese); Mark Arax, *Pooled Cash of Loan Clubs Key to Asian Immigrant Entrepreneurs*, L.A. TIMES, Oct. 30, 1988, § 2, at 1 (explaining that pooled cash from loan associations are financing businesses in Chinatown, Koreatown, and the Vietnamese business areas of the San Gabriel Valley and Orange County, California).

132 *See* LIGHT & BONACICH, *supra* note 129, at 261 ("Institutional lenders in the United States have never been satisfactory sources of capital for new small businesses. . . . Even the Bank of America acknowledged that 'small or embryonic companies' were 'at the bottom of the financing totem pole' because banks preferred to lend to the 'big boys.'").

133 *See* Christine Gorman, *Do-It-Yourself Financing*, TIME, July 25, 1988, at 62. Because rotating credit associations were first observed in less developed economies, it was assumed that they were inefficient precursors to full-fledged banks and that with economic development, they would be replaced by more sophisticated financial insti-

farming villages in the sixteenth century.[134] Similarly, the Chinese hui, which originated in southern China and is founded on kinship, is organized by people who come from the same village, lineage, or clan.[135] The Japanese system, by contrast, is not based on kinship and allows unrelated people from the same district or prefecture in Japan to participate in the association.[136] The West African esusu has long historical roots as well. It was particularly prevalent in the southeastern part of Nigeria, and English-language references to it were made as early as 1794.[137]

Regardless of cultural origin, rotating credit associations share common features. They are designed to serve a social function for their members by promoting community cohesiveness,[138] as well as a financial function by promoting community economic development. Members are organized into a credit group, usually headed by a woman.[139] The leader may also act as an organizer and recruiter and

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tutions. *See* Clifford Geertz, *The Rotating Credit Association: A "Middle Rung" in Development*, 10 ECON. DEV. & CULTURAL CHANGE 241, 260 (1962).

134 *See* Yoshihashi & Lubman, *supra* note 131, at A1; *see also* LIGHT & BONACICH, *supra* note 129, at 244–45.

135 *See* FUKUYAMA, *supra* note 6, at 300.

136 *See* LIGHT, *supra* note 129, at 27–30.

137 *See id.* at 30. Anthgropologists studying the Nigeria's Yoruba people noted:

> There is a society called Esusu. This society deals with monetary matters only, and it helps its members to save and raise money thus: Every member shall pay a certain fixed sum of money regularly at a fixed time (say every fifth or ninth day). And one of the subscribing members shall take the total amount subscribed for his or her own personal use. The next subscription shall be taken by another member; this shall so continue rotationally until every member has taken.

Id. (quoting A.K. AJISAFE, LAWS AND CUSTOMS OF THE YORUBA PEOPLE 48–49 (1924)).

138 Usually, the person who draws from the pot provides the association members with a meal either at her house or at a restaurant. Kye provide more than just financial bonding; it also provides community bonding, and serves as a network for the exchange of business information. *See* Arax, *supra* note 131, at 1 (describing a group of ethnic Chinese from Vietnam and the group's use of the association for both social and investment purposes); Joel Garreau, *For Koreans, "Keh" is Key to Success*, WASH. POST, Nov. 3, 1991, at B1; Merrill Goozner, *Age-Old Tradition Bankrolls Koreans*, CHI. TRIB., July 19, 1987, at C1 (noting the discussion by the president of the Korean-American Drycleaners Associations of the two objectives of kyes: "'[t]o obtain capital or establish a close intimate friendship among the members'").

139 *See* Garreau, *supra* note 138, at B1 ("The Keh . . . was traditionally a women's institution in Korea. This was at least partially because the dirty job of the family finance traditionally was perceived as women's work. But it also reflects its traditional small-scale use—saving to buy a sewing machine, or stock feed for animals through a season."); Gorman, *supra* note 133, at 62 ("The organizer, who is typically female, keeps a record of payments and vouches for newcomers until the club disbands.").

selects members, often based on her assessment of their honesty and dependability.[140] The group decides how much and how often each member contributes to the association and the basis on which money from the association's pool may be drawn, whether by lottery, need, or rotation.[141]

Members belong to the association in order to secure a lump sum of money from others, all of whom pool resources by paying a stipulated amount into the common pot. The organizer arranges a feast for the members and gets the first lump sum, which can be used without restriction or condition. At the next monthly feast given by the organizer, the members again contribute the stipulated sum, and depending on how the group has chosen to determine priority or order of collection, the person next in line—excluding the organizer who has already received the first amount—draws from the pool.[142]

There are various methods for determining priority. Members may determine priority by lottery[143] or simply by need, so that those with urgent financial needs may be moved up to the front of the line.[144] Other credit associations operate on the basis of a bid, and members are required to submit sealed bids indicating the interest they would be willing to pay. Those willing to pay the highest interest would be eligible to receive the lump sum. Under this more competitive system, those who are in financial need would have to compete for the cash, while those who have cash surplus would be able to enjoy the high interest rates and defer their own collection.[145] Among Koreans in the United States, for example, the more sophisticated kyes require members to bid for the pool by agreeing to pay a higher interest rate in exchange for the right of priority, the right to draw on the pool before others.[146] Interest payments running as high as

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For an illustrative study of women's moral reasoning as based on connection to others and contextual in its moral judgment, see CAROL GILLIGAN, IN A DIFFERENT VOICE: PSYCHOLOGICAL THEORY AND WOMEN'S DEVELOPMENT (1982).

140 *See* Szymanski & Song, *supra* note 119, at D1.

141 *See* Helen E. Jung, *Secret to Korean Business Success*, SEATTLE TIMES, Dec. 27, 1992, at A11 (describing how in rotation kyes, members take turns receiving their lump sum, while in bidding kyes members bid and the lowest bidder wins the right to draw and the difference between the total amount in the pot and the bid is distributed to the rest of the members); Sun, *supra* note 130, at A1.

142 *See* LIGHT, *supra* note 129, at 24.

143 *See, e.g.*, Goozner, *supra* note 138, at C1.

144 *See* Gorman, *supra* note 133, at 62; Sugawara & Tucker, *supra* note 131, at A1.

145 *See* LIGHT, *supra* note 129, at 24.

146 *See* Schifrin, *supra* note 131, at 92 (noting that members with urgent financial needs may bid 15% interest on a $100,000 pool and thus draw only $85,00); Garreau, *supra* note 138 (noting that in the high-stakes business kyes with upper limits of

twenty percent would then be deducted from the pool and paid out to the other members.[147] Whether by lottery or by bid, under both scenarios those who have drawn in the earlier rounds are not qualified to draw until every member of the pool has had a chance to collect. Similarly, the amount each member contributes, and hence the value of the common pool, varies from club to club, depending on the members' common understanding.

From an economic standpoint, rotating credit associations perform a valuable dual function. They act not only as a borrowing device but also as a savings device. In many parts of the world, especially the non-Western, noneconomically developed world, rotating credit associations have traditionally "served many of the functions of Western banks. Such associations are, above all, credit institutions which lend lump sums of money to members"[148] and have been found to "'assist in small scale capital formation.'"[149] Those who collect early act as borrowers and those who defer borrowing to collect in the later rounds act as savers. Thus, rotating credit associations provide credit for marginal borrowers[150] as well as promote savings by forcing members to set aside their monthly contribution. Unlike other nonprofit institutions, such as community development banks which are heavily subsidized by the public sector,[151] these associations are entirely self-sustaining and their capital base comes solely from their members'

$100,000, members may offer to pay more for the right to draw on the pool early); Gorman, *supra* note 133, at 62 (describing associations that operate on an interest basis allow bidders who offer the highest interest rate to draw first, although drawers may each draw only once, until everyone else has had his or her turn).

147 *See* Gorman, *supra* note 133, at 62.

148 LIGHT, *supra* note 129, at 23. A large-scale survey undertaken by the Republic of China (Taiwan) Ministry of Justice estimated in 1985 that 85% of the Taiwanese population had participated in the "hui." *See* Jane Kaufman Winn, 25 INT'L LAW 907, 917 nn.58–59 (citing ROC Ministry of Justice, Tai Wan Di Wu Min Jian He Hui Xian Kuang Zhi Yen Jiu [Research on the Current Condition of Rotating Credit Clubs in Taiwan] (1985)); *see also* Goozner, *supra* note 138 ("The Korean kye is a type of rotating credit system found in many Third World societies with underdeveloped banking traditions. Brought to the U.S. by recent immigrants, this cultural tradition—as much a social as a business transaction—is helping fuel the remarkable surge of entrepreneurship by Asian immigrants, especially Koreans . . . .").

149 LIGHT, *supra* note 129, at 23 (quoting Shirley Ardenerr, *The Comparative Study of Rotating Credit Associations,* 94 J. ROYAL ANTHROPOLOGICAL INST. 201, 217 (1964)).

150 Sociologists such as Ivan Light from UCLA have noted the social and economic implications of rotating credit associations. "'There is a hole in our financial system here at the bottom. Look at the stories in the paper of blacks and Chicanos being turned down for mortgages. This shows us how to fill a hole in our system. The potential implications are very great.'" Garreau, *supra* note 138 (quoting Light).

151 *See infra* note 345 and accompanying text.

own contributions. In that sense, they promote independence from rather than dependence on outside funding.

Historically, rotating credit associations have been crucial for the economic development of immigrant communities in the United States, especially because mainstream, majority-owned banks are reluctant to lend to low-income communities[152] and because minority-owned banks have had low success rates and, as a result, have been undependable sources of credit for minority communities. Although 134 banks were owned by African-Americans in the United States between 1884 and 1935, by 1929, only twenty-one had survived, and by 1945, only eleven, which means a failure rate of approximately ninety-two percent.[153] Banks owned by Asians in California in the early twentieth century fared even worse, with a failure rate of 100 percent.[154] Mismanagement has been blamed as the predominant reason for the recurrent failures of minority-owned banks. A 1910 report of the California superintendent of banks stated that "'[t]he Japanese banks now in liquidation . . . are in very bad condition. . . . Their affairs show that they were simply looted.'"[155] Banks owned by African-Americans suffered from similar problems of mismanagement, as well as from economic difficulties arising from a lack of investment opportunities in African-American communities. Banks found themselves "in the position of having to stimulate black business in order to develop investment opportunities for themselves,"[156] resulting in an interlocking network of cross-ownership by banks in a centrally directed "syndicate" of businesses, some of which were unprofitable and required unsound subsidization by the banks.

Rotating credit associations, on the other hand, operate on wholly different principles. Their social capital base allows them to escape the administrative burdens that plague conventional and minority-based banks, resulting in a decrease in transaction costs in both the pre- and post-deal stages. In the United States, both now and in the past, these rotating credit associations have been primarily responsible for the proliferation of fledgling small businesses "in cities as

152 *See supra* notes 26–31.

153 *See* LIGHT, *supra* note 129, at 46.

154 *See id.* Between 1900 and 1920, the Japanese and Chinese opened ten state-chartered banks in California. By 1910, six had closed, with the remainder closed by the mid-1920s.

155 *Id.* at 50. Criminal prosecution was hampered by the fact that records were incomplete and were in Japanese, and by the fact that most of the acts were committed before the Bank Act of 1910 which made them criminal. *See id.*

156 *Id.* at 53.

diverse as Houston, Los Angeles, Chicago and New York."[157] In one of the earliest references to the practice of relying on informal credit mechanisms to capitalize a business, Helen Cather noted, in her 1896 work on the Chinese in San Francisco, that "'[t]he Chinese have a peculiar method of obtaining funds without going to commercial banks. If a responsible Chinaman needs an amount of money, he will organize an association, each member of which will promise to pay a certain amount on a specified day of each month for a given length of time.'"[158] Studies of New York's Chinatown revealed that "'[f]ew Chinese utilized American banks'"[159] and that the Chinese routinely used rotating credit associations, the membership of which was limited to persons from the same village in China,[160] "'to provide capital for fellow members who hope to start businesses.'"[161] Indeed, "'without such societies, very few businesses could be started.'"[162]

Surveys conducted from 1965–66 of foreign-born Japanese in California revealed that almost half reported having participated in some form of mutual assistance, such as pooling money or drawing from the tanomoshi.[163] According to a study published in 1922, mainstream financial institutions in California engaged in systematic discrimination against Japanese businesspeople and farmers.[164] The tanomoshi became a popular credit device because "'a merchant without security [could] thus obtain credit.'"[165] "Possibly without a system of cooperative financing," in fact, "the Japanese would not have developed the economic structure that they did."[166] Similarly, migrants from the British West Indies were particularly entrepreneurial when they arrived in the United States in the early 1900s,[167] in part because of

157 Gorman, *supra* note 133, at 62.

158 LIGHT, *supra* note 129, at 25 (quoting Helen F. Clark, *The Chinese of New York Contrasted with Their Foreign Neighbors*, 53 CENTURY 110 (1896)).

159 *Id.* at 26 (quoting BETTY LEE SUNG, MOUNTAIN OF GOLD 141–42 (1967)).

160 Early on, the Japanese rotating credit association in the United States were limited to members who are from the same village in Japan. *See id.* at 28.

161 *Id.* at 26 (quoting Virginia Heyer, Patterns of Social Organization in New York City's Chinatown, 60–61 (1953) (Ph.D. dissertation, Columbia University)).

162 *Id.* at 27 (quoting GOR YUN LEONG, CHINATOWN INSIDE OUT 177–78 (1936)).

163 *Id.* at 28 (citing John Modell, The Japanese of Los Angeles: A Study on Growth and Accommodation, 1900–1946 (1969) (Ph.D. dissertation, Columbia University)).

164 *See id.* at 29 (quoting Schichiro Matsui, Economic Aspects of the Japanese Situation in California, 86–87 (1922) (M.A. thesis, University of California, Berkeley)).

165 *Id.*

166 *Id.* (quoting S.F. Miyamoto, *Social Solidarity Among the Japanese in Seattle*, 11 UNIVERSITY OF WASHINGTON PUBLICATIONS IN THE SOC. SCI. 75 (1939)).

167 West Indians "'are forever launching out in business, and such retail businesses as are in the hands of Negroes in Harlem are largely in the control of the

their reliance on "the traditional susu credit institution as a savings device."[168]

Although participation in rotating credit associations is widespread among various immigrant communities, few participants are willing to discuss their involvement on the record,[169] partly out of fear that such associations are either outright illegal or in a dubiously gray zone.[170] Nonetheless, it has been estimated that eighty percent of Korean households in the United States belong to at least one kye,[171] with approximately $100 million tied up at any one time in kyes in the Washington, D.C., area alone.[172] Seventy-seven percent of the entrepreneur members of the Korean American Garment Industry Association had participated in a kye upon immigrating to the United States.[173] Kyes in the Washington state region may constitute an approximately $120 million annual regional economy.[174] Ethiopian immigrants without access to formal credit have similarly resorted to the

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foreign-born.'" LIGHT, *supra* note 129, at 33 (quoting W.A. Domingo, *The Tropics in New York*, SURVEY, March 1, 1925, at 648–50.

168 *Id.* at 33; *see also id.* at 34–35. The survival of this traditional African institution in the West Indies but not in the United States has been partially explained by the fact that "[a]ll-black Caribbean islands were hospitable to the perpetuation of African cultural traditions such as the esusu. The outnumbered and subdued blacks in the southern portion of the United States confronted much more formidable barriers to the perpetuation of African cultural traits." *Id.* at 38. In other words, the economic dependence of whites in the British Caribbean on the economy of the slaves meant that the latter were able to maintain economic autonomy in a way not possible in the United States. *See id.* at 38–41.

169 *See, e.g.*, Szymanski & Song, *supra* note 119 ("Numerous kye participants in the Tacoma area declined to talk about their investments in interviews for this story. . . . [and] shroud their participation from everyone but fellow investors or close family members."); Arax, *supra* note 131, § 2 at 1 ("The subterranean nature of loan clubs makes it impossible to quantify their influence. Few members are willing to talk about their participation and even fewer want their names used.").

170 *See infra* note 301; *see also, e.g.*, Szymanski & Song, *supra* note 119 (participants may not report interest income, if any, from kyes, and fear Internal Revenue Service scrutiny).

171 *See* Garreau, *supra* note 138, at B1 ("Koreans are by no means the only immigrants whose culture features rotating credit associations. Ethiopians, West Africans, Central Americans and Caribbean blacks all have similar popular folk institutions, . . . as do Chinese, Vietnamese and Japanese. But no immigrant group in the Washington area has so systematically and successfully translated their gains into entrepreneurial enterprise."); *see also* Rhonda Richards, *Two Sides of the American Dream*, USA TODAY, May 12, 1992, at 1B.

172 *See* Garreau, *supra* note 138, at B1.

173 *See* Jefferson, *supra* note 130, at R13; Arax, *supra* note 131, § 2 at 1 (citing a 1987 study by Ivan Light, a sociology professor).

174 *See* Szymanski & Song, *supra* note 119, at D1.

ekub, a "mutual assistance savings plan to which members contribute a set amount of money each week."[175] "[W]hile the American saying is that lending money to a friend is the most effective way to end a friendship, the Ethiopians . . . say that the willingness to lend money is, in fact, a test of friendship."[176] The principle of trust around which rotating credit associations are organized is itself "faithful to the Latin from which 'credit' derives: credere—'to believe.'"[177]

Trust makes it possible for members of rotating credit association to take on the commitment to adhere to group norms, including its "no law" understanding. As "informal, small-scale banks organized primarily by immigrants to help one another . . . , [the associations] operate outside regular U.S. banking laws and safeguards."[178] The groups determine their own rules outside the framework of formal laws or regulation. Contracts are not written and there are no loan agreements. The associations function strictly on "an unwritten honor code."[179] Money deposited into the associations is not backed by deposit insurance. There are no processing, accounting, or legal fees associated with conventional bank loans. Nor are collateral or credit checks required.[180]

Such a high level of trust is possible partly because of "preexisting social ties based on kinship or geographic residence in the native country"[181] and because of a long tradition against subjecting community practices to the framework of public law. Studies found that the esusu practiced by descendants of West African slaves in the British Bahamas in 1910 operated entirely outside the realm of formal laws. "These 'Asu' have no written statutes or regulations, no regular officers, but carry on their affairs without fraud or miscalculation."[182]

Norms of trust and reciprocity make cooperation possible and ensure that the borrower honors her obligation to repay by continuing to contribute regular sums into the pool until every member has had

175 Sugawara & Tucker, *supra* note 131, at A1.

176 *Id.*; *see also* Sun, *supra* note 130, at A1.

177 David Bornstein, *The Barefoot Bank with Cheek*, ATLANTIC MONTHLY, Dec. 1995, at 40.

178 Gorman, *supra* note 133, at 62.

179 Szymanski & Song, *supra* note 119, at D1.

180 Garreau, *supra* note 138, at B1. The principles that govern these associations are not much different from those that govern transactions among Jewish merchants in New York's diamond industry. Among diamond dealers in the industry, a handshake along with the words "mazel u'broche" constitutes a binding agreement. *See* Bernstein, *Opting Out*, *supra* note 97, at 121.

181 FUKUYAMA, *supra* note 6, at 301.

182 LIGHT, *supra* note 129, at 32 (quoting HARRY H. JOHNSON, THE NEGRO IN THE NEW WORLD 303 (1910)).

an opportunity to draw. Every member of the rotating credit association must be secure in the knowledge that all others "will continue to show up and pay their share every month, long after they have received their own payoff"[183]—in other words, that a common interest in group incentive and deterrence will provide borrowers with the motivation to repay.

Additionally, since reputational sanctions represent an important source of norm enforcement,[184] shaming has been used as a particularly effective enforcement mechanism in a variety of settings, for example, in transactions among Orthodox Jewish dealers in the diamond industry of New York City. The Diamond Dealers Club bylaws provide that "'[a]ll decisions of arbitration panels . . . which are not complied with within 10 working days, together with the picture of the non-complying member, shall be posted in a conspicuous place in the Club rooms.'"[185] Similarly, members of an Ethiopian ekub claim that "'it's easier to commit suicide'" than to renege because loss of community standing is "'not like credit. It won't clear after seven years.'"[186] Because rotating credit associations are embedded in the community, default would result in expulsion from the association, resulting in "shame on not just the individual, but that person's family. It likely would lead to difficulty in getting a job [in the community] or even getting a marriage partner."[187] When a member who has already borrowed can no longer contribute to the pool because of financial difficulties, it is understood that the association member "will go to great lengths to borrow the money from a friend or relative or another member of the keh, or persuade someone else to take his

183 Garreau, *supra* note 138, at B1.

184 *See supra* notes 112–23.

185 Bernstein, *Opting Out*, *supra* note 97, at 128. Arbitrators who resolve disputes among diamond dealers may also invoke a proceeding in Jewish rabbinical courts against the party who refuses to comply with the arbitrators' decision. "Because these courts have the authority to ban an individual from participation in the Jewish community, this is a powerful threat against Orthodox members of the diamond industry." *Id.* at 130. Arguably this level of formality is much greater than the sanctioning norms subscribed by less decentralized groups such as rotating credit associations. *See* Charny, *supra* note 77, at 1841–42.

186 Sun, *supra* note 130, at A1.

187 Garreau, *supra* note 138, at B1. In instances of default, the organizer of the club, who is given some rights and privileges—for example, either the right to draw first, or the privilege of receiving the loan interest free—is usually held responsible for covering the club's losses. *See* Gorman, *supra* note 133, at 62. Where individual club members do not have personal connections with one another, their decision to join the club is based primarily on the organizer's reputation.

place in the keh—anything rather than default."[188] As a member of the Korean Association of Greater Washington remarked, "'If you owe to someone personally, you will work the rest of your life to exonerate yourself. . . . It's a matter of face. The family name would go down the drain forever.'"[189]

Such duty-imposing norms make it possible for systems that operate outside the framework of the open market and public law to function effectively. It is often assumed that the market and market institutions are determined more by the establishment of legal institutions, such as property and contract laws, than by development and "accumulation of social capital."[190] Yet, even in robust, well-functioning markets, contract law and the open market cannot solve all market difficulties.[191] Other factors may need to be taken into consideration, for example, how certain norms further the production of social capital[192] and what role social capital has in shaping economic behavior and in facilitating, with minimal transaction costs, the formation and enforcement of other types of socially useful community contracts. As I demonstrate below, norms that promote a wealth of social capital also translate into a concrete system of group information exchange that facilitates mutual screening, monitoring, and enforcement, which in turn lowers transaction costs and facilitates the formation of an alternative community market for credit.

B. Information Asymmetries, Transaction Costs, and Rotating Credit Associations

Through an overarching regime of informal community norms, the borrowers that the formal economy has deemed not to be creditworthy[193] are granted access to credit from lenders who rely on

188 Garreau, *supra* note 138, at B1.

189 *Id.*

190 FUKUYAMA, *supra* note 6, at 11.

191 *See supra* Part I.

192 One of the main themes of this Article is that the law should not operate in a way that results in the destruction of social capital. *See infra* Part IV. For an analysis of how social capital can be destroyed by law, see Richard H. Pildes, *The Destruction of Social Capital Through Law*, 144 U. PA. L. REV. 2055, 2062–63 (1996).

193 "For Roscas [rotating savings and credit associations] . . . to operate successfully it is necessary that individuals keep their commitment to pay into the Rosca after they have won the pot. This may appear problematic since Rosca members are often not able to borrow in conventional credit markets precisely because they cannot be presumed to repay such loans." Timothy Besley et al., The Economics of Rotating Savings and Credit Associations, Research Program in Development Studies, Woodrow Wilson School of Public and International Affairs, Princeton University, Discussion Paper No. 149, May 1990, at 3.

custom and usage, not state law, to ensure repayment and to resolve disputes among community members. By relying on the borrowers themselves to screen, monitor, and enforce group loans, the association in essence relies on the actors who have the necessary informational advantage. Rather than being a perversion or avoidance of the open market, rotating credit associations are an instance of private ordering or community market that allows members to contract back into community-embedded relationships in order to lower transaction costs and generate economic exchanges which the open market could not rationally accommodate.

As my discussion demonstrates, seemingly mundane practices, such as those adopted by rotating credit association members, implicate major, age-old issues in social and political theory. Since Hobbes identified the problem of social disorder,[194] many theories have been offered to explain how to avoid the state of nature in which covenants are routinely broken and property rights are routinely invaded. According to social contract theory, in a state of nature, whenever two people enter into an agreement they always face at least two choices, whether to keep or break the agreement. To minimize uncertainty and to ensure that contracts entered into will be kept, both parties, the theory maintains, will choose to cooperate by entering into a social contract to establish a state that will maintain order and enforce the rules of the game.[195] The state thus emerges as an antidote to the state of nature and as a central source of law and order.

Since then, modern social theory has questioned whether social order is a product of deliberate design[196] or whether it may also

194 *See* THOMAS HOBBES, LEVIATHAN (Richard Tuck ed., 1991) (1651).

195 *See* JAMES M. BUCHANAN, THE LIMITS OF LIBERTY: BETWEEN ANARCHY AND LEVIATHAN (1975).

196 *See* 1 F.A. HAYEK, LAW, LEGISLATION AND LIBERTY: RULES AND ORDER 8–34 (1973). According to Hayek, the "view . . . that human institutions will serve human purposes only if they have been deliberately designed for these purposes," *id.* at 8, can be traced to Rene Descartes' view of reason and rational action. As Hayek stated,

> [s]ince for Descartes reason was defined as logical deduction from explicit premises, rational action also came to mean only such action as was determined entirely by known and demonstrable truth . . . and that therefore everything to which man owes his achievements is a product of his reasoning thus conceived. . . . The 'rationalist' approach . . . produced a renewed propensity to ascribe the origin of all institutions of culture to invention or design. . . . This intentionalist or pragmatic account of history found its fullest expression in the conception of the formation of society by a social contract, first in Hobbes and then in Rousseau, who in many respects was a direct follower of Descartes.

emerge by social evolution[197] through decentralized but loosely coordinated and repeated interactions among individuals and groups. Given the high cost of protecting against opportunistic behavior, businesses have resorted to vertical integration and long-term contracts to protect against opportunism and to lower transaction costs.[198] As Part II demonstrates, it is also possible for order to arise spontaneously from repeated and cooperative interactions among private groups. Where exchanges are personalized, "the costs of contracting are embedded within repeat dealings and personal knowledge of the performers; and as a consequence, the costs of contracting and enforcement are lower than in impersonal exchange, when one must specify as precisely as possible the nature of the exchange and the enforcement procedures."[199] Thus, order is maintained via a private ordering of cooperative interactions that in turn minimizes opportunistic behaviors.

Under conditions of high uncertainty, such as information asymmetry and enforcement difficulties involved in lending to marginal

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Id. at 10. For a discussion of Cartesian rationalism, see G. DE RUGIERO, HISTORY OF EUROPEAN LIBERALISM 21 (R.G. Collingwood trans., 1927); H.J. LASKI, STUDIES IN LAW AND POLITICS 20 (1922).

197 *See* 1 HAYEK, *supra* note 196, at 146–47. Hayek attributes the evolutionary approach to the English common law tradition as expounded by Matthew Hale. Under this view,

> orderliness of society which greatly increased the effectiveness of individual action was not due solely to institutions and practices which had been invented or designed for that purpose, but was largely due to a process described at first as 'growth' and later as "evolution," a process in which practices which had first been adopted for other reasons, or even purely accidentally, were preserved because they enabled the group in which they had arisen to prevail over others.
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> . . . .
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> . . . . It came increasingly to be seen that the formation of regular patterns in human relations that were not the conscious aim of human actions raised a problem which required the development of a systematic social theory. . . .

Id. at 9, 22. Such theory was provided by Adam Smith and Adam Ferguson in the field of economics and Edmund Burke in political theory. Wilhelm von Humboldt and F.C. von Savigny systematically applied the evolutionary approach to social phenomena, and Savigny's follower, Sir Henry Maine, applied it to the social sciences.

198 *See, e.g.*, WILLIAMSON, *supra* note 86. Oliver Williamson and Douglass North are some of the leading proponents of new institutional economics, *see supra* note 86, termed "new" to distinguish it from an earlier school of economics led by John R. Commons and Thorstein Veblen which had also analyzed institutions. *See, e.g.*, JOHN R. COMMONS, INSTITUTIONAL ECONOMICS: ITS PLACE IN POLITICAL ECONOMY (1934); THORSTEIN VEBLEN, THE THEORY OF THE LEISURE CLASS (1912).

199 Douglass North, *The New Institutional Economics*, 142 J. OF INSTITUTIONAL & THEORETICAL ECON. 230, 230–37 (1986).

borrowers, trust, identity, and "social and ethical behavioral norms influence the costs of contracting,"[200] and are especially important devices for overcoming information costs[201] that impair the performance of markets.

The dissemination of information "has important public goods attributes"[202] and "reduces the transactions costs attributable to asymmetric information."[203] Norms "embody and convey information,"[204] including information about community expectations and community sanctions. Members of the association have access to the community's reservoir of information, share a common understanding of the community's social meanings, and rely on the community's interpretive traditions to facilitate their individual and collective ends. In these closely knit communities, both predeal information gathering and postdeal enforcement will be relatively friction-free and cheap. Consequently, this bottom-up, decentralized approach to lending is particularly effective for small loans, especially uncollateralized ones, that formal lenders find inefficient to lend and administer.[205]

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200 *Id.*

201 *See* NEIL K. KOMESAR, CHOOSING INSTITUTIONS IN LAW, ECONOMICS, AND PUBLIC POLICY 101–03, 115–21 (1994). Professor Komesar singles out information costs as a particularly significant cause of problems in decisionmaking, in the market, in the political and judicial processes. *See* George A. Akerlof, *The Market for 'Lemon': Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970). Information asymmetries between buyer and seller may produce a "lemons" problem with dangerous products, driving safe ones out of the market. If safe products sell for a higher price because they are more expensive to produce and if consumers cannot tell the difference between safe and unsafe products, safe products will be priced out of the market. Information asymmetry between the producer and the consumer, in which the former has information while the latter does not, lets "lemons" dominate the market. For an analysis of the negative impact information on economic actors in this case, see generally Steve Salop, *Information and Market Structure: Information and Monopolistic Competition*, 66 AM. ECON. REV. 240 (1976).

202 Stephen Craig Pirrong, *The Efficient Scope of Private Transactions-Cost-Reducing Institutions: The Successes and Failures of Commodity Exchanges*, 24 J. LEGAL STUD. 229, 241 (1995).

203 *Id.* at 242.

204 Katz, *supra* note 19, at 1749.

205 Mutual screening and monitoring are easier and more cost-effective in smaller groups than in larger groups. *See* Joseph Stiglitz & Andrew Weiss, *Peer Monitoring and Credit Markets*, 4 WORLD BANK ECON. REV., 351, 351–66 (1990).

There is a rise in what has been called "affinity fraud," that is, con artists using commonality of ethnic, religious, career, or community-based groups to swindle victims out of their savings by pitching, often through the telephone, nonexisting business opportunities or selling unregistered securities to unsophisticated buyers. *See Affinity Fraud: Beware of Swindlers Who Claim Loyalty to Your Group*, <http://www.nasaa.org/investoredu/investoralerts/ethnicaffinity.html>; Susan Antilla, *'Affin-*

By virtue of their structure and operational norms, rotating credit associations contain certain built-in mechanisms that provide informational remedies to lower *screening* costs that have constrained banks in the formal sector. Rather than rely on the formal market as the site of rational economic behavior, rotating credit associations rely on social norms and personalistic transactions embedded within the community itself to act as built-in information-gathering devices, thus bypassing informational hurdles in the open market.[206]

Little, if any, information asymmetry exists between the rotating credit association and its members. The group has ample information concerning the identity, history, and background of its members at its disposal. Indeed, perhaps even more so than formal banking institutions, because the effectiveness of rotating credit associations is especially dependent on extralegal norms, access to information on the identity and trustworthiness of its members is crucial. "In a market where enforcement depends on social ostracism or reputational damage, the formation of an extralegal contract depends on information about reputation"[207] and functions essentially as a very low-cost substitute for the formality of legally sanctioned contracts.

In addition to lowering screening costs, the same social and cultural factors, such as ethnicity, identity, and community, also allow the association to *monitor* borrowers; in this case, more perfect information serves as a substitute for traditional collateral and other security devices required by formal lenders. Principal-agent literature is replete with observations about the costs that principals must assume in order to monitor the actions of their agents.[208] However, while it may

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ity' Scamsters Betray Trust Based on Ethnic, Religious Links, N.Y. OBSERVER, Dec. 29, 1997 at 1; David R. Sands, *In the Land of the Free: Con Artists Show Affinity for Ripping of their Own*, WASH. TIMES, Nov. 10, 1991, at A13. The issues that make such incidents of fraud possible, however, are not present in rotating credit associations. The latter are based not just on a general and abstract claim of common ethnicity, but rather on personalized trust founded on membership in a small circle of common culture and ethnicity.

206 *See supra* notes 40–52 and accompanying text.

207 Bernstein, *Opting Out*, *supra* note 97, at 133.

208 The separation of ownership and control in a large firm creates agency problems because the modern corporation is run not by the owners and shareholders but by their agents and managers, whose goals may not coincide with those of the owners and shareholders. *See* ADOLPH A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). This principal-agent problem creates various agency costs. According to Jensen and Meckling, agency costs are the totality of "1) the monitoring expenditures of the principal, 2) the bonding expenditures by the agent, and 3) the residual loss." Michael C. Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. OF FIN. ECON., 305, 308 (1976). Residual loss is loss resulting from potentials not realized due

be costly for principals to monitor the actions of their agents, other monitoring mechanisms allow the agents to monitor themselves or each other at comparatively lower costs.[209] Rotating credit associations directly address and alleviate the high costs of monitoring caused by asymmetric information between borrowers and lenders. Bottom-up peer monitoring, one of the key features of rotating credit associations, allows those in the best position to monitor the borrower to do this monitoring themselves.

This concept is essentially based on one of joint liability. In rotating credit associations, there are two layers of monitoring, first from the organizer and second from the members themselves. The association's organizer, who is also a member of the group, acts as the guarantor for the group and monitors the group as a whole, as well as each rotating borrower. When members of a rotating credit association do not all know each other, they rely on the organizer, who has the informational advantage, to testify to the trustworthiness of those invited to participate in the association. The organizer acts to screen members, as well as to monitor their performance.[210] The organizer is liable if a member who has collected from the pool defects from the group and refuses to deposit her share in the next round of contribution, or additionally, if a member who has not borrowed yet cannot come up with her share on time for another to draw on.[211]

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to the inability of principals to provide the correct incentives for agents because the agents' actions cannot be observable. *See also* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, at 301 (1983); R. Rees, *The Theory of Principal and Agent, Part I*, 37 BULL. ECON. RES., 1, 3–26 (1985).

209 *See* Hal R. Varian, *Monitoring Agents with Other Agents*, 146 J. INSTITUTIONAL AND THEORETICAL ECON. 153, at 153 (1990).

210 The organizer may select members based on their reputation for honesty and dependability. *See* Szymanski & Song, *supra* note 119, at D1. ("The kye-joo [organizer] has heavy responsibility for the kye's success. He or she keeps any records, collects monthly payments and distributes the monthly pot."). A similar concept is also used in the heavily Orthodox Jewish diamond industry in New York, where brokers are used "to gather information about individuals' reputations for trustworthiness at a lower effective cost than individual buyers and sellers because a broker's investment is less transaction specific." Bernstein, *Opting Out*, *supra* note 97, at 133.

211 *See* Arax, *supra* note 131, § 2, at 1 ("The master picks or clears all members and therefore must cover all defaults."); Gorman, *supra* note 133, at 62 (organizer held responsible for covering club's losses in cases of default). Similar principles also govern the extralegal contractual relations in the diamond industry. The New York Diamond Dealers Club, for example, which has its own private regime of rules to govern relationships among its members, requires out of town dealers to be "sponsored" by members before admission to the trading hall. A member in good standing must agree "to assume 'full financial responsibility (guarantee) for the out of town dealer's

Consequently, the organizer performs the role of information gatherer and processor before including potential members in the pool and continues to monitor the member during the economic life of the pool. The joint liability rules of the association induce the organizer to utilize community knowledge to ascertain each member's creditworthiness, social assets, and social traits; in other words, the member's social collateral.[212] Because identity and trust matter and act as low-cost signals for minimizing risks in exchange relations, the screening and monitoring costs incurred by the organizer, herself a member of the community, are relatively lower than the costs that conventional banks would incur to assess lending risk and borrowers' creditworthiness. "Trust is an important lubricant of a social system"[213] and is itself a "commodit[y] [with] . . . real, practical, economic value."[214]

The second layer of monitoring comes from the group itself which, by its selection or approval of members, functions on the basis of mutual accountability and acts as an internal monitoring mechanism of itself and its members. The group will have better information about its members than a financial institution. The fact that the group itself is composed of members from the same community allows the group to resort to "group incentive mechanisms"[215] to engage in mutual monitoring. Presumably, on the basis of self-selection, members would agree to form a rotating credit association with other members only if they are satisfied that others are relatively good credit risks and thus would require relatively minimal monitoring. That any member who has drawn from the pool could theoretically stop her own contribution to the pool means that members choose to interact with each other only on the assumption that each member's internalization of community norms and/or community constraints, such as reputational sanctions, are sufficient to minimize opportunistic behavior. In other words, each person agrees to participate only if she can trust that the other person—as each others' and the group's agent—

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acts and liabilities, incurred while on the premises of the DDC.'" Bernstein, *Opting Out*, *supra* note 97, at 119 n.5 (quoting the Diamond Dealers Club Bylaws).

212 See, for example, Magagnini, *supra* note 130, at B1, for an interview of a Cambodian immigrant who said many Cambodians belong to the credit association "'because we cannot go to the bank. We don't have anything (as collateral). But there has to be trust. If someone cannot pay, my dad (as the dealer) has to come up with the money. You must play with people in business where their word is good as gold.'"

213 KENNETH J. ARROW, THE LIMITS OF ORGANIZATION 23 (1974).

214 *Id.*

215 Varian, *supra* note 209, at 155.

will act as good agents. "If there is no cost to locating good agents . . . , then the agents will certainly find it in their interest to only group themselves with good agents."[216]

The high costs of *enforcement* have also posed a significant barrier to the development of a formal capital market for low-income borrowers and low-income communities. The institutional arrangements supporting rotating credit, however, are markedly different from those that underlie conventional banking practices because they rely on both internal compliance as well as group-based, self-enforcement schemes to ensure repayment by borrowers. First, a group member, more likely than not, has internalized the group's norms and hence is more likely to comply with the rules of the game. Second, that the "lender" is the group of which the borrower is a member also increases *compliance* and hence the likelihood of repayment because the loan commitment is not to an outsider or an impersonal, distant lender such as a bank, but to a member of the community and the group. Although it is essentially a business institution designed to provide credit to members in need of capital, the rotating credit association is also a community-based endeavor that functions in the same way that the Diamond Dealers Club in New York functions—as "an old-fashioned mutual-aid society."[217] If loan delinquency occurs, it would not be merely an instance of external loan delinquency but rather delinquency against the entire group, and consequently against the social fabric of the group and the community of which the group is a part, in which case the group as well as the larger community could sanction delinquent borrowers by imposing social penalties, such as moral persuasion and ostracism.

By relying on the logic of norms and the claims of community, rotating credit associations are able to correct informational asymmetries[218] inherent in standard lender-borrower relationships and thus minimize the high transaction costs inherent in formal lending to resolve the central paradox that the formal sector has yet to resolve:

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216 *Id.* at 160.

217 Bernstein, *Opting Out*, *supra* note 97, at 139 (The club "provides kosher restaurants for its members. A Jewish health organization provides emergency medical services, and social committees are organized by neighborhood to visit sick members and their families. There is a synagogue on the premises, and contributions to a benevolent fund are required.").

218 But correcting informational asymmetries through the provision of information may not be possible or worthwhile if, as Professor Sunstein noted, it is too costly. *See* Cass R. Sunstein, *Informing America: Risk, Disclosure, and the First Amendment*, 20 FLA. ST. U. L. REV. 653, 665–67 (1993). High cost would not be an issue in the case of rotating credit associations.

establishing a market for loans to borrowers who possess none of the conventional criteria used by banks to determine creditworthiness.

IV. Open Markets And Community Markets

If social capital is related to economic efficiency and if social solidarity lowers the cost of borrowing for rotating credit association members, the next question is how to preserve a community lawmaking system that produces a significant social benefit with little, if any, social cost.

In Part A, I examine the role of the state in general and courts in particular in furthering or enforcing community norms. My argument is that the state should refrain from interfering with the function of rotating credit associations. In this respect, I argue for a judicial policy of "community nonjusticiability"[219] favoring dismissal of cases involving disputes between or among community members. In the alternative, if and when, in certain limited circumstances, judicial resolution is appropriate, the court should decide the dispute under standard contract law by enforcing the parties' understanding of community norms and custom. Part A examines rotating credit associations and argues that an incentive structure arising from an aggregation of interests among members serves to maximize group welfare and minimize group abuse, making the case for judicial application of group norms most persuasive.

In Part B, beyond the issue of exploring whether, under what circumstances, and to what extent the state should defer to and enforce private custom, I also examine how socially efficient and wealth-maximizing norms that emerge from a community market can be promoted. For example, how can banks incorporate some of the efficiency benefits of rotating credit associations? And can state-promoted entities, such as community development banks, replicate the structural benefits of rotating credit associations?

A. Community Nonjusticiability and Community Norms

It is not uncommon for private groups to insist on the exclusivity of their own dispute resolution mechanisms by prohibiting members from resorting to formal litigation.[220] Perhaps due to the strength of

219 *See infra* note 228 and accompanying text.

220 *See* Bernstein, *Merchant Law*, *supra* note 97, at 1788; *see also* Bernstein, *Opting Out*, *supra* note 97, at 124–27, 134 ("Rational transactors might deliberately leave aspects of their contracting relationship to be governed, in whole or in part, by extralegal commitments and sanctions."). An analogous situation can be drawn to certain business sectors—the securities industry, for example—that require members to sub-

community norms against resorting to judicial resolution of disputes, there have been very few reported lawsuits brought by rotating credit association members.[221] In addition, enforcement of private arrangements is rarely accomplished by litigation because of high costs and because "parties are rarely willing to pay the reputational price of violating [the] norm [of secrecy] simply to gain access to the courts."[222] Nonetheless, there have been some disputes where the plaintiff has ignored the group's "no law" understanding and asked the court for relief.

One of the factors to be considered by judges and other decisionmakers in evaluating whether to use formal laws and their own cost-benefit analysis, or defer to the community's informal norms in resolving community-based disputes, is the normative component of the community custom at issue. A business norm may emerge from an industry and govern solely the relations among members within the community. At some point, however, community rules may push beyond the boundaries of the private order and intersect with public law, for example, when insiders look to the apparatus of the state to resolve their disputes. Then it is appropriate to ask what the response of the state should be. On the one hand, one may question whether certain behaviors that may constitute norms, for example, norms of racial discrimination[223] or price-fixing, should be encouraged and en-

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mit to arbitration and the industry's arbitration rules as the exclusive mode of dispute resolution. As a general rule, courts have upheld the parties' forum selection clauses. *See, e.g.*, M/S Bremen v. Zapata Off-Shore Co., 407 U.S. 1 (1972); Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585 (1991); *see also* Mitsubishi Motors v. Soler Chrysler-Plymouth, 473 U.S. 614 (1985) (upholding arbitration clauses). For a discussion of how norms are relied upon by merchants in industries that ordinarily shun formal adjudication, see Robert Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CAL. L. REV. 2005, 2040–42 (1987).

Some industries such as the grain industry even prefer that courts enforce formal rules and do not attempt to discern and enforce the business norms of grain merchants, for fear that courts will be unable to understand the norms they seek to enforce. *See* Bernstein, *Merchant Law*, *supra* note 97, at 1796–1807.

221 A search through the state and federal court databases reveals one reported case in 1928 in Honolulu. *See* Choi Heylin v. Shin Sung Yil, 30 Haw. 606 (Haw. 1928). There are discussions of and references to disputes and law suits among rotating credit associations members in the popular press. *See, e.g.*, Szymanski & Song, *supra* note 119, at D1. However, none of the suits has resulted in any reported decision except one in Los Angeles.

222 Bernstein, *Opting Out*, *supra* note 97, at 135.

223 The issues surrounding possible claims of racial discrimination arising out of rotating credit associations are complex. They are derived from community cohesiveness and to a large extent, homogeneity. Inclusion of insiders often involve exclusion of outsiders. Suppose a non-Vietnamese sued under the civil rights laws, such as

forced by the state.[224] Custom, therefore, cannot be decisive at all times.

On the other hand, when private communities have a comparative advantage over both formal markets and governmental institutions and produce rules that are both wealth-maximizing and efficient, the social capital base of such communities should be preserved. In that case, when disputes arise between community members over community norms and members turn to neutral third-party arbiters, such as courts, for resolution, what courts should *not* do is engage in decisionmaking that destroys the community's social capital base. A recent court decision dismissing a case on the basis that a Korean kye was an illegal lottery[225] and that the participant's debt therefore could not be collected in an American court is an example of ill-considered judicial action that shapes economic preferences in a way that may lead to the distortion of community markets. Although the result is defensible, the reasoning is starkly misconceived. My proposal is as follows. As a general rule, a court should abstain by adopting a "hands-off, nonjusticiability" posture. Or alternatively, under exceptional circumstances when it decides to hear the case, it should attempt to locate or discover group norms—find the law, in other words—and defer to such norms in the resolution of group disputes,[226] especially when "the gain from better enforcement exceeds the cost of formalization."[227]

Under the first possible scenario, a court should abstain from entertaining the case pursuant to a "community nonjusticiability" approach. "Community nonjusticiability" makes sense because it is

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§ 1981, claiming a race-based exclusion from a Vietnamese rotating credit association? Besides the statutory and constitutional issues, one may also ask how a liberal society that promotes liberal values of inclusion and heterogeneity should accomodate community enclaves that are premised upon nonliberal values of exclusion and homogeneity? These issues will be addressed in a forthcoming article.

224 *See, e.g.*, Cooter, *supra* note 2, at 1694–96. For a discussion of how law should treat private preferences, when to ratify preferences and when to reject preferences, see, for example, Cass R. Sunstein, *Legal Interference with Private Preferences*, 53 U. CHI. L. REV. 1129 (1986); Robin L. West, *Taking Preferences Seriously*, 64 TUL. L. REV. 659 (1990).

Nor are all norms efficient in all cases. Examples include norms of honesty which "interfere with efficiency by preventing people from exploiting their investments in private information." Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1697, 1705 (1996) (citing Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 17–18 (1978)).

225 *See infra* note 302 and accompanying text.

226 *See* ELLICKSON, *supra* note 78, at 283; Robert C. Ellickson, *Property in Land*, 102 YALE L.J. 1315, 1320–21 (1993).

227 Cooter, *supra* note 2, at 1684.

worse for courts to apply the wrong norms than not to hear the case at all, as the former could result in a distortion of efficient community norms[228] and hence endanger the community's repository of social capital.[229]

Superimposing formal adjudicatory devices on informal community devices would undermine the very community norms that give community-based exchanges certain comparative advantages over open market exchanges. The possibility that the entire panoply of law backed by a formal judicial process lurks behind every rotating credit association will result in the transformation of its very essence—founded on a commitment to informality, community, and flexibility. As Professor Walter Weyrauch has observed in his study of the law of small groups, every small group produces its own background norms of operating principles and, through its own group dynamics, generates rules of conduct for its members.[230] Professor Weyrauch found in his study that the rules of the group are not to be articulated and indeed that if a rule is articulated, either accidentally or deliberately, it will be discarded. Thus, "If the new rules are formally articulated as changes, so that participants become fully conscious of the fact that changes are taking place, then those changes might be rejected."[231] The act of articulation itself effects a change in group behavior.

Similarly, the act of formalizing an informal norm, through the introduction of rights language, will effect a change in community interaction, as formalization of informality through the force of state law will destroy the social capital base of trust that makes informality possi-

228 Not all norms are fair or efficient. Fairness and efficiency are strong reasons for judicial deference to norms. For a discussion of a "structural approach" where courts would decide whether to enforce a social norm by inquiring into its underlying incentives, *see* Cooter, *supra* note 2.

229 *See infra* notes 288–303 and accompanying text. Judge Edward M. Ross's decision in the Superior Court of California holding that a kye is a lottery demonstrates a complete misunderstanding of the workings of a kye. As noted by Ivan Light, the decision "highlights the difficulty that American law encounters when attempting to digest foreign savings and credit institutions like the kye." Ivan Light, *Lending Support to Kyes*, L.A. TIMES, Oct. 24, 1993, at 22.

230 *See* Walter O. Weyrauch, *The 'Basic Law' or 'Constitution' of a Small Group*, J. SOC. ISSUES, Mar. 1971, at 49, 53, 59, *reprinted in* LAW, JUSTICE AND THE INDIVIDUAL IN SOCIETY: PSYCHOLOGICAL AND LEGAL ISSUES (June L. Tapp & Felice J. Levine eds., 1977).

231 Weyrauch & Bell, *supra* note 2, at 375. For a critique, see W. Michael Reisman, *Autonomy, Interdependence, and Responsibility*, 103 YALE L.J. 401 (1993). Reisman argues that this insight should be limited only to certain circumstances: "[t]he notion that new rules should not be articulated because articulation would slow the process of change may hold true in the context of rules that are inconsistent with the myth system . . . ." *Id.* at 411.

ble.[232] "Once the language of rights gets started, we do think of our moral relations in a different way. . . . It is as if a different 'game' were being played, whose elements have functions that are different from those they previously had."[233] There are different types of relationships and communities, ranging from personal to impersonal and long-term to short-term, and different types of language may be more applicable to some communities and relationships than to others. My argument is that "rights and rights language are more appropriate to some of the forms of community than to others"[234] and, specifically, absent extraordinary circumstances, not as appropriate for communities constituted by close ties founded on norms of trust, cooperation, and reciprocity.

Besides *declining* a case at the outset pursuant to "community nonjusticiability," the court may also, in exceptional circumstances, *accept* it and, pursuant to the group's "no law" agreement, enforce the group's understanding and dismiss the case. This second approach may be termed the "contract" approach, as opposed to the "community nonjusticiability" approach, because judicial deference to community understandings accords with basic principles of contract law.[235] When the court enforces the parties' "no law" understanding, it is, in fact, holding the group and its members to their own reasonable expectations: that theirs was a "gentleman's agreement" which, as defined in the Oxford English Dictionary, is an "agreement which is not enforceable at law and which is only binding as a matter of honour."[236] Assuming that "[t]he parties have capacity and competence, act in good faith, and suffer no lack of information or defect of con-

232 In the movie "The Magnificent Seven," the hero was told that his promise to protect the village against pillage by bandits would never be enforceable in court. His reply: "That's the sort of promise that you have to keep." *See* Bernard Rudden, The Gentleman's Agreement in Legal Theory and in Modern Practice, General Report of the Comparative Law Conference, 15th Congress, in Bristol, England, 1998, at 1.

233 Martin G. Golding, *The Significance of Rights Language*, PHIL. TOPICS, Spring 1990, at 59–60.

234 *Id.* at 61.

235 First, all members knew of and favored community informality, including the norm against judicial resolution of disputes, when they joined the group. An analogous concept can be located in tort law. The parties have, in effect, knowingly assumed the risk that should the bargain not work out as they had hoped and expected, they could only resort to internal means of dispute resolution and would be left without external, judicial recourse.

236 THE OXFORD ENGLISH DICTIONARY 453 (2d ed. 1989), *cited in* Rudden, *supra* note 232, at 1. *See also* Herbert Bernstein & Joachim Zekoll, *The Gentleman's Agreement in Legal Theory and in Modern Practice: United States*, 36 AM. J. COMP. L. 87, 87 n.1 (1988). ("A gentleman's agreement is an agreement which is not an agreement, made between two persons, neither of whom is a gentleman, whereby each expects

sent,"[237] and that they have assented with each other to enter into a "gentleman's agreement" which is to have no legal consequence, then, under the consent theory of contracts, no legally enforceable obligations can follow.[238] According to the Restatement (Second) of Contracts, "Parties to what would otherwise be a bargain and a contract sometimes agree that their relations are not to be affected. In the absence of any invalidating clause, such a term is represented by the law like any other term . . . ."[239] In other words, "the freedom of contract carrie[s] with it the freedom not to contract."[240] Other national jurisdictions also support this approach,[241] believing that if the parties can subject their agreement to a certain law through a choice of law clause, they should also be free to choose no law.[242]

On the other hand, countervailing issues may cause a court to ignore the parties' "no law" understanding and consider some other

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the other to be strictly bound without himself being bound at all.") (quoting Bloom v. Kinder [1958] T.R.91)

237 Rudden, *supra* note 232, at 2.

238 *See* Wendell H. Holmes, *The Freedom Not to Contract*, 60 TUL. L. REV. 751, 753 n.5 (1986) (listing sources discussing the approach of the United States and England which favors the right of the parties to agree not to subject their agreement to law). It is beyond the scope of this Article to delve into the general case law or into select individual cases that address this complex issue. My argument that courts should honor these particular types of "gentleman's agreements" is one made with the particular context of rotating credit associations in mind.

239 RESTATEMENT (SECOND) OF CONTRACTS § 21 (1981). *See also* 1 E. FARNSWORTH, CONTRACTS § 3.7, at 116 (1982) ("The easiest way for a party to make clear his intention not to be legally bound is to say so. In a number of commercial contexts, parties enter into 'gentlemen's agreements that state that they are not legally binding, and it is beyond question that the parties can in this way turn an otherwise enforceable agreement into an uneforceable one."). Whether or not the participants in rotating credit associations expressly and verbally state their agreements to perform their obligations and settle their differences outside the realm of law, there is little doubt that the norms of the associations call for "no law." *See supra* notes at 169–89. There are exceptions, as the Restatement itself anticipates, "where a bargain has been fully or partly performed on one side, a failure on the other side may result in unjust enrichment . . . ." RESTATEMENT (SECOND) OF CONTRACTS § 21 (1981).

240 Holmes, *supra* note 238, at 752.

241 The German reporter to the 15th Congress Comparative Law Conference noted that "'the legal order can intervene only where the parties have expressly stated that their declarations of intention shall produce the legal consequences." Rudden, *supra* note 232, at 3. The Japanese report noted that "'gentleman's agreements operate through a tacit understanding of the parties, rather than by express disclaimer. . . . Japanese doctrine agrees that there are many instances of contextual no-law in social relations among friends and family." *See id.* at 2.

242 Using the same analogy, if the parties can choose arbitration through an arbitration clause and exclude the courts, they should be able to choose an "honors only" option and exclude legal order. *See id.* at 3.

legal principle or relation,[243] for example, notions of fairness and unjust enrichment as between the parties[244] or notions of market efficiency and social justice.[245] There is an element of paternalism in the law that may be proper—though as I argue, paternalism is not appropriate in judicial resolution of most rotating credit disputes.[246] Paternalistic interventions have been justified on the basis that the actors' volitional faculties are limited because they are minors, mentally disabled, or intoxicated at the time of their agreement; that private choices, under some circumstances, are not really private and endogenous but rather, to a large extent, socially constructed;[247] that the parties' choices derive from an overly narrow set of options and are not truly informed, but instead are misconceived;[248] that people's cognitive abilities are limited in a number of important ways, leading them to make erroneous choices;[249] that their actual preferences may

243 The law in some national jurisdictions concerns itself with the question of whether private parties can agree to strip courts of their authority to decide cases. Some jurisdictions—Japan, for example—are uncomfortable with a generalized no-law agreement or clause "which does not specify any particular dispute [as] that would not accord with public order." Rudden, *supra* note 232, at 5. The Spanish position is "'that the parties cannot determine for themselves when a given relationship will or will not be legally binding.'" *Id.* (citation omitted). According to the Italian reporter, "'the Italian legal tradition is not completely ready to accept the idea that the parties themselves can decide on the nature of their commitment, be it legal or only moral.'" *Id.* (citation omitted).

244 *See* RESTATEMENT (SECOND) OF CONTRACTS § 21 (1981).

245 A court faced with a private agreement that might result in some unfair restraint of trade but that also contains a "no-law" understanding between the parties may ignore the "no-law" understanding in order to enforce other concerns such as market efficiency. Similarly, the court may also ignore a "no-law" understanding among the parties to perform an agreement to discriminate on the basis of race. These are examples of private preferences, the gratification of which might cause harm to others. *See generally* Sunstein, *supra* note 224, at 1129.

246 Some of the examples of legal paternalism are: mandatory seatbelt use while driving, mandatory safety measures in high-risk work environments, mandatory social security arrangements, compulsory elementary schooling, the doctrines of unconscionability and undue influence, and the limited enforceability of some contract terms such as liquidated damages and forfeiture clauses. *See* Eyal Zamir, *The Efficiency of Paternalism*, 84 VA. L. REV. 229, 230 (1998).

247 *See id.* at 236.

248 *See, e.g.*, Sunstein, *supra* note 224, at 1138–41 (1986); *see also* Zamir, *supra* note 246, at 237 ("[T]here seems to be no reason why frustrating one's actual preferences cannot, in appropriate circumstances, maximize her overall happiness. A person's belief that a certain course of action will yield the greatest happiness for herself may be misconceived. Obstructing an action rooted in such a misconception may increase the person's happiness despite the displeasure involved in having one's preferences frustrated.").

249 *See* Zamir, *supra* note 246, at 237.

conflict with their second-order preferences, so that while they may choose to engage in certain conduct, they in fact wish to have their choices paternalistically frustrated;[250] or that their private preferences inflict harm on others.[251]

On the other hand, personal freedom and autonomy are themselves important. Should the parties enter into an agreement that is subject to a "no law" understanding, "freedom from contract, if regarded as of benefit to society, also needs to be protected, lest the increasing concern for fairness and good faith develop into a paternalistic imposition that in the end will prove deleterious to commerce"[252]—or, as in this case, to the very incentive structure that makes rotating credit associations the unique entities that they are. Paternalistic intervention is unnecessary unless there is clear evidence that the plaintiff lacks the necessary mental condition to understand the norms that govern rotating credit associations, or that force, duress, or fraud was involved. If, for example, the organizer made deliberate misrepresentations to the plaintiff by telling the plaintiff that she would be joining a kye and the plaintiff later discovered, after several rounds of "contributions," that the organizer and the other members had set her up only to take her money, there would be no reason for a court to abstain from a civil suit or for the prosecutor to abstain from initiating criminal prosecution as well.[253] Otherwise, paternalistic interventions are more difficult to justify under most circumstances. For example, while it is true that the parties' choice to participate in a credit association is itself the result of a lack of choice in the formal, open market, paternalistic intervention that results in the distortion of community markets will only result in a further contraction, not maximization, of available options.

The question of judicial enforcement of, and deference to, private understandings has been explored in a slightly different although

250 See Sunstein, *supra* note 224, at 1129, for the argument that second order preferences justify paternalism. For example, a person who acts recklessly and prefers not to use seatbelt may herself wish she were more prudent. Such a person may also approve of paternalistic intervention designed to frustrate her first-order preferences.

251 *See id.* at 1131

252 Bernstein & Zekoll, *supra* note 236, at 95.

253 As reported in the Tacoma, Washington press in 1996, a woman, Ms. Kyung Hee Yi, organized multiple, separate kyes that totaled 100 investors. For reasons publicly unknown, she did not make payments to investors as required. When some investors, many of whom had not met each other, confronted Ms. Yi, she told them kye funds were not available. The sherriff's office was called. Ms. Yi was arrested. However, she was not charged with a crime because "investigators found so little paperwork associated with Yi's kyes that they doubted they could mount a successful prosecution." Szymanski & Song, *supra* note 119, at D1.

sufficiently analogous context.[254] The understandings and bylaws adopted by voluntary, private associations, for example, generally set forth not only the benefits to be conferred upon members, but also the association's rules regarding how disputes among members and the association will be resolved.[255] Major League Baseball, a self-governing private association of baseball clubs, grants the Commissioner broad powers to sanction any act not in the best interests of baseball.[256] The Major League and the constituent clubs also severally agree "'to be finally and unappealably bound by such actions and severally waive such right of recourse to the courts as would otherwise have existed in their favor.'"[257]

When challenges to the Commissioner's authority have been brought, the Commissioner's power to impose remedial or punitive sanctions without judicial interference has been upheld by the courts. In a case challenging the Commissioner's "best interests of baseball" clause, the Seventh Circuit held that the parties had voluntarily contracted to grant the Commissioner authority to forbid recourse to the courts.[258] The court also found that even in the absence of a "waiver of judicial recourse" provision, "'it is generally held that courts . . . will not intervene in questions involving the enforcement of bylaws and matters of discipline in voluntary associations.'"[259] Thus, the "no judi-

254 I thank Professor William Van Alstyne for suggesting the comparison with the law of private associations.

255 Private voluntary associations usually have internal disciplinary codes and are governed by rules agreed to by the members. For example, Major League Baseball has its own disciplinary process independent from judicial interference. *See* Jeffrey A. Durney, *Fair or Foul? The Commissioner and Major League Baseball's Disciplinary Process*, 41 EMORY L.J. 581 (1992).

256 My discussion of Major League Baseball as an example of private associations that enjoy a high degree of autonomy and noninterference by courts is drawn from Jeffrey A. Durney. *See id.*

257 *Id.* at 587.

258 *See* Charles O. Finley & Co. v. Kuhn, 569 F.2d 527 (7th Cir. 1978), *cert. denied*, 439 U.S. 876 (1978).

259 American Fed. of Tech. Eng'rs v. La Jeunesse, 347 N.E.2d 712, 715 (Ill. 1976) (*cited in Kuhn*, 569 F.2d at 545 (Fairchild, J., concurring)). *See also* Van Daele v. Vinci, 282 N.E.2d 728, 731 (Ill. 1972); Engel v. Walsh, 101 N.E. 222, 223 (Ill. 1913).

In a separate concurring opinion, Chief Judge Fairchild disagreed with the majority's "sweeping holding that the waiver of recourse to the courts provision, unless narrow exceptions exist, is 'valid and binding on the parties and the courts.'" *Kuhn*, 569 F.2d at 545. Citing to an Illinois case which held that agreements designed to oust the courts of jurisdiction are void as contrary to public policy, *see In re* Streck's Estate, 183 N.E.2d 26, 31 (Ill. App. Ct. 1962), Judge Fairchild noted that although the scope of judicial review of the Commissioner's decision is extremely narrow, the Commissioner's decision could be overturned if the owner could establish that the Commissioner acted with bias or malice.

cial recourse" clause "can be upheld as coinciding with the common law standard disallowing court interference."[260]

Indeed, courts have long recognized that private associations may select their own system of self-governance and self-discipline.[261] "[I]t is well-established that a voluntary association may, without direction or interference by the courts, draw up for its government and adopt rules, regulations and by-laws which will be controlling as to all questions of . . . doctrine or internal policy."[262] Absent compelling circumstances, such as abuse of discretion or arbitrary invasion of private rights, courts will not interfere with questions concerning the association's "'policy, doctrine, or discipline. . . . Courts will compel adherence to the charter and to the purpose for which the society was organized, but they will not do more.'"[263] The only rights and duties courts need to address are those "created by the private law of the parties, insofar as such contract rights did not exceed statutory bounds or conscionable reaches."[264] Generally speaking, then, "there should be no judicial interference with the internal affairs, rules and by-laws of a voluntary association unless their enforcement would be arbitrary, capricious or constitute an abuse of discretion."[265] Indeed, "Only the most abusive and obnoxious by-law provision could prop-

260 *Kuhn*, 569 F.2d at 543.

261 *See* Durney, *supra* note 255, at 596 ("'[T]he courts have been very hesitant to intervene in any self-governing private organization. Otherwise there would be a flood of lawsuits every time some woman didn't win the presidency of the local flower club.'") (quoting Professor Gary Roberts whose comments can be found in Tom Verducci, *Appeal? Forget It Boss*, NEWSDAY, July 26, 1990, at 125).

262 6 AM. JUR. 2d, *Associations and Clubs*, § 5, at 433 (1963) (citations omitted).

263 Orchard Ridge Country Club, Inc. v. Schrey, 470 N.E.2d 780, 783 (Ind. Ct. App. 1984) (quoting Supreme Lodge, Knites of Pythias v. Knight, 117 Ind. 489, 496–97 (1889). *See, e.g.*, Hebert v. Ventetuolo, 480 A.2d 403 (R.I. 1984) (upholding Rhode Island Interscholastic League's suspension of students based on the league's rules governing eligibility of transfer students to participate in interscholastic athletics against the claim that such participation is a constitutionally protected right); Caso v. New York State Pub. High Sch. Athletic Ass'n, 78 A.D.2d 41 (N.Y. App. Div. 1980) (refusing to interfere with the association's internal affairs upon finding that the voluntary association of schools adhered to its own rules and that the plaintiff had violated the rules, resulting in his ineligibility to participate in certain sports competitions); Crandall v. North Dakota High Sch. Activities Ass'n, 261 N.W.2d 921, 926 (N.D. 1978) (finding that the association's eligibility rules are not arbitrary or unreasonable and refusing to "determine the wisdom of such rules when they are reasonable").

264 Leon v. Chrysler Motor Corp., 358 F. Supp. 877, 886 (D.N.J. 1973), *aff'd* 474 F.2d 1340 (3rd Cir. 1973).

265 *Hebert*, 480 A.2d at 407 (citations omitted). The Rhode Island court found that the defendant Rhode Island Interscholastic League may promulgate rules governing the eligibility of transfer students to participate in interscholastic sports.

erly invite a court's intrusion into what is essentially a business thicket."[266]

As a general and relatively clear-cut proposition, rotating credit associations, like other private voluntary associations, should be allowed to promote and enforce norms that govern the group's internal affairs. Although there are no express written rules and regulations similar to those in the Major League Agreement, or those in the bylaws and articles of incorporation that typically govern many associations, the norms adhered to by members of rotating credit associations are as much an expression of community self-governance as the rules and regulations enacted by the more formal associations. Additionally, that the norms of rotating credit associations emerge rather "spontaneously" from a normative system characterized more by the evolving nature of the parties' interactions than by a "centralized agency for formulating or enforcing rules"[267]—whether it be written contractual rules that make up the nonlegal but comprehensive governance regime of Major League baseball, the American grain industry, or the Japanese products liability system[268]—should not matter for the purpose of the present inquiry.

The defining issue as far as judicial enforcement of an association's private law is concerned is not whether the understandings adopted by a private association consist of written rules of conduct and comprehensive procedures of enforcement, but rather whether or not the private association operates within an "institutional environment" with its own background constraints or "rules of the game," so to speak, that guide individual behavior. "Institutional environment," as used by Professors Lance Davis and Douglass North, refers to background rules which can be either formal, explicit rules or informal, implicit ones, such as social conventions and norms.[269]

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266 *Leon*, 358 F. Supp. at 885.

267 Charny, *supra* note 77, at 1845.

268 *See supra* notes 93–99 and accompanying text for a discussion of norms that evolve via informal but regularized interactions among members of groups versus norms that arise from a centralized, "state-like" agency. In the former scenario, the nonlegal regime—for example, of ranchers in Shasta County, California or of participants in rotating credit associations—consists of norms that derive from rather "informal and diffuse sanctioning systems." Charny, *supra* note 77, at 1845. In the latter scenario, as Professor David Charny noted, the nonlegal governance regime is "established in a two-step process: first, norms evolve as a result of transactors' dealings (as in the grain industry) or industry consensus (standards identifying 'design defects'); second, the centralized agency selects among, codifies, and enforces these norms." *Id.* at 1841.

269 Peter G. Klein, New Institutional Economics, at 3 (July 1998) (unpublished paper on file with author) (citing LANCE E. DAVIS & DOUGLASS C. NORTH, INSTITU-

> While these background rules [the institutional environment] are the product of—and can be explained in terms of—the goals, beliefs, and choices of individual actors, the social result (the rule itself) is typically not known or "designed" by anyone. Institutional arrangements, by contrast, are specific guidelines . . . designed by trading partners to mediate particular economic relationships. Business firms, long-term contracts, public bureaucracies, nonprofit organizations, and other contractual agreements are examples of institutional arrangements.[270]

To the extent that courts routinely defer to the "institutional arrangements"—the specific rules, regulations, or guidelines established by private voluntary associations—the same deference should be accorded to the "institutional environment"—the norms, social conventions, or "rules of the game" that structure social conduct within rotating credit associations.

In some circumstances, which I discuss below, it may be appropriate for a court to hear the case, although again, judicial resolution should be the exception rather than the rule.[271] In such cases, as I have argued, the court should look to community norm and practice, custom, and usage, rather than perform a traditional cost-benefit analysis, which calls for judges to choose among alternative rules by comparing and contrasting their costs and their benefits.[272] "[P]rivate parties are apt to have better information about their own positions than the state, even if their information is . . . itself highly imperfect."[273]

TIONAL CHANGE AND AMERICAN ECONOMIC GROWTH (Cambridge University Press 1971)).

270 *See id.*

271 *See infra* notes 301–07 and accompanying text.

272 *See* Epstein, *supra* note 103, at 5–6.

> Although championed by Landes and Posner, Steven Shavell, and other conservative economists, the cost-benefit formula is, when generally applied, far more *interventionist* than the standard of care based on custom. The cost-benefit tests are used to challenge the rationality of markets, while formulas based on custom accept and rely on some level of implicit rationality in market bahavior.

Id.

273 Richard A. Epstein, *Issues in Tort Reform: The Risks of Risk/Utility*, 48 OHIO ST. L.J. 469, 471 (1987); *see also* Epstein, *supra* note 103, at 24 ("The substantive differences between the two approaches—custom and cost benefit—are enormous. When custom is used, the courts can, in effect, function in a *reactive* fashion, relying on the practices formulated by those who have powerful incentives to get things right because of the daily peril in which they labor.").

Others have adopted a pragmatic approach: "if public policymakers have good reason to think that a given private norm is efficient, based on their own independent

Although the issues in this Article concern the law of contracts rather than the law of torts, the controversy over methodology—the relevance of custom versus an independent cost-benefit approach—has been especially pronounced in tort cases. In a standard cost-benefit approach, for example, courts use the Learned Hand rule espoused in the landmark case *United States v. Carroll Towing Co.*[274] to determine negligence, that is, to assess if "the burden of adequate precautions"[275] undertaken by a defendant would be less than expected savings in liability.[276] In that case, a barge which broke loose from a mooring collided with other vessels. Because there was no community standard to govern the duty of the bargee, Judge Hand applied his own cost-benefit analysis to determine whether or not the defendant should be found negligent and hence liable for damages to other vessel owners.

But where custom exists and is discernible, and where a person behaves as others in like circumstances, one may infer that she is acting in conformity with community standards of reasonableness.[277] "In particular instances, where there is nothing in the situation or in common experience to lead to the contrary conclusion, this inference may be so strong as to call for a directed verdict . . . ."[278] As Judge Posner noted in *Rodi Yachts, Inc. v. National Marine, Inc.*,[279] "the focus of the . . . court's inquiry should be on the parties' respective compliance with and departures from the customs . . . ,"[280] especially because of the parties' "reasonable expectations that the firms with which they deal are complying with the standard of care customary in the indus-

analysis, they should defer to it, and if they have good reason to think it inefficient, they should not defer." Katz, *supra* note 19, at 1752.

274 159 F.2d 169 (2d Cir. 1947).

275 *Id.* at 173.

276 My discussion relies on Professor Robert Cooter's comparative evaluation of a cost-benefit analysis versus a deference to custom analysis in tort law. *See* Cooter, *supra* note 2, at 1678–82.

277 *But see* The T.J. Hooper, 60 F.2d 737 (2d Cir. 1932). This case, also decided by Judge Hand, denies any conclusive weight to custom and complements the cost-benefit formula he later adopted in *United States v. Carroll Towing Co.*, 159 F.2d 169 (2d Cir. 1947). Judge Hand's view has received widespread acceptance among courts and commentators. *See, e.g.*, Bimberg v. Northern Pac. Ry., 14 N.W.2d 410, 413 (Minn. 1944) ("Local usage and general custom, either singly or in combination, will not justify or excuse negligence. They are merely foxholes in one of the battlefields of law, providing shelter, but not complete protection against charges of negligence.").

278 RESTATEMENT (SECOND) OF TORTS § 295A cmt. b (1974).

279 984 F.2d 880 (7th Cir. 1993) (holding that compliance with custom is a defense to a tort claim in a case where a barge broke loose and caused damage to other vessels.).

280 *Id.* at 888–89.

try . . . [and because] these customs appear to reflect an undistorted market determination of the best way to minimize" costs.[281]

It has been suggested that an approach that favors deference to custom is analogous to the English model of adjudication and accommodation which arose in the eighteenth century when the formal legal system found itself increasingly in contact with the practices of merchants who had developed their own norms to regulate trade.[282] Medieval law merchants, enforced by the threat of ostracism, developed out of a system of private courts established by English merchants to resolve disputes among themselves. As the English legal system came into increasing contact with cases involving general merchant practice, English judges faced commercial disputes which had once been handled privately.[283] Rather than make new rules or substitute their own for the merchants, English judges "tried to discover those rules that already existed among the merchants, and then selectively enforced them,"[284] deferring, in other words, to merchant custom.

There are efficiency benefits to this approach because, where appropriate, deference to custom is cost-effective. "[M]ost situations are not distinctive or novel but fall into certain repetitive patterns,"[285] and thus most business communities have developed "simple rules of thumb and standard practices to guide them in their daily work."[286] Someone who relies on existing custom for his interactions

> can now rest in relative comfort on the knowledge that others with greater experience and knowledge have adopted a pattern of doing business on which he can sensibly free ride. Custom is a socially desirable form of free riding that offers a cheap and reliable source of information about a form of agreement that is worthy of use because of the impersonality and universality of its origins.[287]

The customary norms of rotating credit associations are precisely the type of norms to which the state should defer.[288] They arise out of

281 *Id.* at 809. Of course, whether or not a market decision is efficient may be determined by a cost-benefit analysis. Economists, however, understand that the information required to conduct a complete analysis may not be available and thus "answer the question indirectly, by discussing market structure and firm behavior." Cooter, *supra* note 2, at 1680.

282 *See* Cooter, *supra* note 2, at 1648.

283 *See generally* Bruce L. Benson, *The Spontaneous Evolution of Commercial Law*, 55 S. ECON. J. 644, 644–61 (1989).

284 Cooter, *supra* note 2, at 1648.

285 Epstein, *supra* note 143, at 6.

286 *Id.*

287 *Id.* at 10.

288 *See* Katz, *supra* note 19, at 1752.

consensual arrangements among willing participants and are contract, not tort, cases. Thus, these norms register the preferences of parties to the custom, not strangers or third parties who are victimized by it. Unlike tort cases, no victims are injured by acts arising from credit arrangements who are not already members of the community and already insiders party to the custom.[289] Additionally, as Part III of this Article demonstrates, a rotating credit association represents a healthy instance of private ordering governed both by norms of the market and norms of community ethics. First, there is a long and rich history of immigrant participation in such associations, which has played a crucial role not only in the financial viability of immigrant communities, but also in their social and cultural cohesiveness. Second, these associations have survived and continue to be relied upon, especially by new immigrants who lack credit histories and collateral, precisely because the formal financial market is incapable of transcending the high transaction costs due to informational asymmetry between borrowers and lenders in the open market. Third, the associations must be seen, therefore, as a rational and efficient community response to open market imperfections through community market formation.

Here, the market preference for efficiency and wealth maximization is consonant with, rather than detrimental to, the values of community reciprocity and commitment that market critics claim are devalued by market behaviors.[290] The market, it has often been charged, presumes and takes as self-evident individual autonomy and thus atomizes the individual from his larger society "by tangibly rewarding narrowly self-interested behavior, by penalizing altruism, and by devaluing commitment."[291] Furthermore, there has been a rising sense of concern that the dominance of the global economy will result in an economic hegemony that "wipes out" local markets and possibly "erases" local culture and local communities.[292] Wal-Mart, one of the largest retailers in the United States, for example, has been facing significant opposition to its expansion into certain communities and neighborhoods because of the fear that its overwhelming economic prowess will result in the decimation of smaller stores owned by local,

289 *But see supra* note 223.

290 *See, e.g.*, MICHAEL SANDEL, DEMOCRACY'S DISCONTENT (1996).

291 Allen E. Buchanan, *Assessing the Communitarian Critique of Liberalism*, 99 ETHICS 852, 866 (1989).

292 *See genereally* Taibi, *supra* note 5, at 961 (analyzing the ways in which transactional capital and the global economy "undermin[e] the economic, cultural, and social foundations of non-elite communities").

independent merchants.[293] In a highly competitive age, markets in general, and capital markets in particular, whether they be global or national,[294] are driven by concerns that transcend local interests in ways that may be detrimental to community concerns.[295] It is thus all the more important that the decentralized exercise of community initiatives and the utilization of local institutional resources, which result in local market economic investment in ways that are inclusive of underrepresented groups, be supported rather than impeded.

The norms that govern rotating credit associations and guide the behaviors of members maximize cooperation and commitment for the purpose of creating economic value for their economically marginalized members. Members interact with each other not as atomized individuals but as community members who utilize and marshal their community membership to maximize individual as well as group interests. In other words, economic value is dependent not on disaggregation but instead on an aggregation of interests.[296]

While formal institutional lending operates on the premise that lenders and borrowers are disaggregated entities likely resulting in high transaction costs for lenders, rotating credit associations work only if "lenders" and "borrowers" constitute a single entity with convergent commitments. The "lender" in a rotating credit association is itself the borrower and vice-versa; stated another way, a member func-

293 *See* Ellen Neuborne, *David Beats Goliath in Wal-Mart Pricing War*, USA TODAY, Oct. 13, 1993, at B1; Fran Silverman, *State's Communities Put up a Wall of Resistance to Wal-Mart*, HARTFORD COURANT, Nov. 28, 1994, at A3.

294 *See* Enrique Carrasco & Randall Thomas, *Encouraging Relational Investment and Controlling Portfolio Investment in Developing Countries in the Aftermath of the Mexican Financial Crisis*, 34 COLUM. J. TRANSN'L L. 539 (1996) (analyzing the impact of highly mobile capital investment, as opposed to more long-term investments such as foreign direct investment, on the national economies of less developed countries in general and that of Mexico in particular).

295 By now there is a voluminous amount of criticism directed at the global corporation and its encroachment in and destruction of the local market. For recent popular articles that address this issue, see, for example, Richard J. Barnet, *Lords of the Global Economy*, NATION, Dec. 19, 1994, at 754; Richard J. Barnet, *The End of Jobs*, HARPER'S, Sept. 1993, at 47; Jeremy Brechner & Tim Costello, *Taking on the Multinationals*, NATION, Dec. 19, 1994, at 757; Noam Chomsky, *Notes on NAFTA: 'The Masters of Mankind,'* NATION, March. 29, 1993, at 412.

296 One can also make the case that trust is necessary to restrain force or fraud. *See* Granovetter, *supra* note 65, at 489. But it is also true that "networks of social relations penetrate irregularly and in differing degrees in different sectors of economic life, thus allowing for . . . distrust, opportunism, and disorder . . . ." *Id.* at 491. While trust is certainly an important element in a rotating credit association, it is the aggregation of the interests of the group and its members that most effectively curbs abuse, coercion, or force against group members by the group.

tions both as a "lender" and as a "borrower,"[297] resulting in a confluence of interests between "lender" and "borrower." The "lender" is capitalized by its members. Membership in the association aligns the interests of "lender" with "borrower" and those of "borrowers" with other "borrowers," so that there are fewer problems of information asymmetry and hence a minimization of screening, monitoring, and enforcement costs.[298] The group plays both the role of the market and the community. Default by one member represents a wrong committed against not just the other members but against the association itself.

This aggregation of interests produces an institutional structure that acts as a disincentive against defection or default and also against abuse, specifically abuse by the group against its individual members. Membership is voluntary, and members are selected because the organizer, as the guarantor, and the other members, as participants, have mutually screened each other. Information that governs group exchanges is symmetrical rather than asymmetrical, and thus members are not uninformed "lenders" or "borrowers." The terms and conditions of participation derive from mutual agreement, and the enforcement mechanisms are founded on community norms that emerge from the bottom up, not from the top down. This aggregation of interests and the incentive structure derived therefrom distinguishes rotating credit associations from other coercive institutions, such as the loan shark. The difference is not simply the most obvious one, that shaming is different from physical beating and murder. Even in those rare instances when interest on a rotating credit association loan rises to a level of twenty percent[299] or more, a rotating credit association is still different from a loan shark—precisely because the aggregation of interests between the group and its members acts as a significant built-in check against impulses toward group exploitation and abuse.[300]

I have thus far argued that courts should either decline a case that involves a rotating credit dispute under "community nonjusti-

297 When member A contributes to a pool and member B draws, A can be deemed a lender and B a borrower. When A draws in the next round, A is then the borrower and B, who has drawn and can no longer draw until everyone has drawn, is then the lender. If analyzed from a group rather than an individual level, one also can say that the group is the lender and the members are the borrowers.

298 *See supra* notes 206–18 and accompanying text.

299 *See supra* note 147 and accompanying text.

300 *See* Eric Posner, *The Regulation of Groups*, 133 U. CHI. L. REV. 133, 170 (1996) ("One doubts the importance of usury laws and corporate laws, which are designed to protect uninformed borrowers and investors, when the members share ties of kinship, friendship, and community.").

iciability" or else take the case but, guided by the law of voluntary associations, adopt a "contract" approach and defer to private norms. I have also argued that norm deference is appropriate because the norms of rotating credit associations are consonant with values worth promoting: wealth maximization, efficiency, community reciprocity, and trust. If the norm of the group is one of "no law," then a court should "enforce" this norm and defer to it, that is, resolve the case by "finding" the law of the group and applying it to the dispute at hand.

My argument that community norms should be controlling in judicial resolution of disputes can be illustrated in the following case. Currently, it is unclear whether rotating credit associations are legal or illegal, and a recent California case only muddles the picture further.[301] In 1993, a dispute began when the Songs, a Los Angeles couple whose relative had declared bankruptcy and stopped making his own monthly payment into another kye, were asked by the organizers to supply collateral to secure future payments into the pot before the couple would be allowed to collect.[302] No other kye member had been asked to provide security. When the couple refused and were told by the organizers that they could not collect from the pot, they refused to make further contributions. The organizers sued in the Superior Court of Los Angeles for the amount the Songs were obligated to contribute as their monthly sum. The judge dismissed the case upon finding that the kye is itself an illegal lottery and also a form of security which was being sold without prior permission from the proper authorities.

While the state has interests in protecting entities that deliver a collective good as well as in preventing fraud or violations of state law, the judge's decision accomplishes neither objective. First, as Eric Posner suggested in a recent article, the assumption that

> the kye [was] a lottery was erroneous. Lotteries appeal only to risk takers because the cost of the ticket exceeds the expected payout. A share in a kye, however, like a savings account with a bank or a loan from a bank, appeals to anyone who seeks to flatten out his con-

301 *See* Robert Reinhold, *The Koreans' Big Entry into Business*, N.Y. TIMES., Sept. 24, 1989, at A4 ("The kye . . . is fast, efficient, effective—and quite illegal under American law."). Under California law, rotating credit associations like the kye are not regulated. *See* Kenneth Howe, *Lending Clubs Collapse Amid Fraud Charges*, S.F. BUS. TIMES, June 29, 1987, § 1, at 1; *see also* Douglas Frantz, *Hanmi Bank Uses Ancient Asian Lending Practice To Help Koreans*, L.A. TIMES, Oct. 5, 1988, § 1, at 1 (discussing whether or not the failure of kye members to report interest income on their tax returns constitutes a violation of the tax codes).

302 *See* Kenneth Reich, *Private Investment Pools Dealt Blow*, L.A. TIMES, Sept. 25, 1993, at B1.

sumption over time; the member's contributions, adjusted for interest, equal his expected payout.[303]

Second, although it is unclear whether this particular kye had violated tax or usury laws, it is also questionable whether or not such laws are necessary or effective against the communal background norms of kyes. "One doubts the importance of usury laws and corporate laws, which are designed to protect uninformed borrowers and investors, when the members share ties of kinship, friendship, and community."[304] And third, there is no functional difference between kyes versus the many instances in which "'friends put money in, make a pool and give personal loans for educational expenses or a business without the paperwork, collateral, credit checks and high rate of rejection involved with bank loans."[305]

It should be emphasized that the decision to file a complaint is itself an anomaly, as the norm against resorting to formal judicial process to resolve community disputes is usually quite strong.[306] Under normal circumstances, nonlegal sanctions would likely have been sufficient to force both the organizers and the Songs to come to an acceptable resolution of the dispute. The suit, however, arose in the aftermath of the Los Angeles riots, when the devastation of the Korean-American community made the threat of nonlegal sanctions such as community ostracism less effective, and hence defection from community norms more attractive. One could view the riots as the equivalent of a *force majeure* event justifying the institution of a lawsuit in contravention of community norms in order to enforce those norms.

In ruling that the organizers had no legal recourse to collect debts from those who participated in kyes because the kye was itself an illegal entity and the entire arrangement was presumably null-and-void, the judge failed to recognize the social function of kyes in community development and, by his threshold decision, kept the court from looking beneath the veil of formality and state regulation to the

303 Posner, *supra* note 300, at 174–75 n.118. *See also* Ivan Light, *Lending Support to Kyes*, L.A. Times, Oct. 24, 1993, § 1, at 22 ("The associations are not lotteries in any ordinary meaning of the term, so they cannot be illegal lotteries. Lotteries afford players only a slim probability of recouping even their original investment. In contrast, the associations guarantee all participants the return of their principal. The only uncertainty concerns how soon they get their money back.").

304 Posner, *supra* note 300, at 170.

305 Jake Doherty, *An American Wrinkle in Korean Loans*, L.A. TIMES, Oct. 3, 1993, § 1, at 3 (quoting Benjamin B. Hong, Chief Executive Officer of Harris Bank).

306 *See* ELLICKSON, *supra* note 78, at 60–64; Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 61 (1963).

underlying custom that governs the activities of such credit associations. Assuming that the court would have been correct in hearing the case—in other words, assuming that the case constituted a legitimate, though rare, instance in which judicial resolution was appropriate—the question should have been recast to allow the court to examine whether fraud or bad faith was involved.

Once it took the case, the court should have located the law that governs the expectations and behavior of kye members in the same way that courts do when faced with an issue of industry custom or usage among merchants.[307] Some of the questions the court could and should have asked include: was there a norm that allowed the organizers to demand collateral of kye members? If such a norm did not exist among kye members, was it nonetheless an expectation among members of this particular kye? Was the couple that asked to produce collateral justified in refusing to make additional payments? Was it understood that collateral could be demanded under certain limited circumstances to protect the security of the kye, if relatives of kye members were discovered to experience financial difficulty? In other words, was it the accepted custom that the respective social capital bases of the participants consisted not just of their own but also that of their relatives? If so, were the organizers justified in demanding economic security, if kyes function well only in the context of family as well as community stability and cohesiveness?

Judicial nonintervention—or in exceptional cases warranting intervention, the application of the group's own norms as I have advocated—should work unproblematically in nearly all cases. However, there might still be some potentially disturbing issues to be addressed. Although it is clear that the parties involved in a kye have explicitly or implicitly agreed to subject themselves to the rules of the association, one still wonders about the extent to which courts should enforce the "no law" norm, especially when an act performed by a group's members in accordance with group norms causes ancillary harm to one or more of the members. Should the court still enforce the "no law" norm by deferring to it, effectively declaring that it will not hear a common law claim for restitution?

For example, suppose that someone defaults on her contributions "without cause," so that the defaulter has in essence defected

307 For an analogue, see The Uniform Commercial Code, which allows course of dealing, usage of trade, or course of performance to be considered in the interpretation of express contract terms. *See* U.C.C. § 1-205(1) (1991). "[T]hese sources may not only supplement or qualify express terms, but in appropriate circumstances, may even override express terms." 1 JAMES J. WHITE & ROBERT SUMMERS, UNIFORM COMMERCIAL CODE, § 3-3, at 121 (4th ed. 1995).

from the group after having drawn her contribution from the common pool.[308] The group as a whole, or an individual member of the group who would have been the next eligible drawer, takes the necessary enforcement action against the defector, designed to heap shame upon the defector and deter others from defecting. An ad is placed in the local paper identifying the person as an untrustworthy person who has failed to meet her obligation to the association. As a result, her reputation is damaged and her business (assume she owns a small, service-oriented business) suffers. Group members telephone her persistently to berate her. Her children are accosted and told of their mother's disgraceful behavior. The defector, in other words, is alternately harassed and shunned from the community.[309] She sues for invasion of privacy, intentional infliction of emotional distress, and tortious interference with her business. Should the court decline to hear the case, in essence ratifying the group's sanctions against a wayward member in deference to its norms of shunning and shaming? The answer depends on the facts of the case, and courts should, as I propose below, balance the norms and needs of the community with other areas of paramount state concern.

Shunning has been used by religious groups such as the Amish, the Mennonites, and the Jehovah's Witnesses to maintain and enforce religious unity and cohesiveness.[310] Shunning can cause a shunned person to lose her spouse,[311] children,[312] business,[313] and overall standing in the community.

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308 I thank Professor William Van Alstyne for posing the following hypotheticals and for suggesting comparisons with religious shunning cases.

309 For a general discussion of various theories of ostracism, see OSTRACISM: A SOCIAL AND BIOLOGICAL PHENOMENON (Margaret Gruter & Roger D. Masters eds., 1986). *See also* Margaret Gruter, *Ostracism on Trial: The Limits of Individual Rights*, 7 ETHOLOGY & SOCIOBIOLOGY 271 (1986).

310 In the Amish community, *Bann und Meidung*, which means excommunication and shunning, require "that members receive no favors from the excommunicated person, that they do not buy from or sell to an excommunicated person, that no member shall eat at the same table with an excommunicated person, and if the case involves husband or wife, they are to suspend their usual marital relations." Justin K. Miller, Comment, *Damned If You Do, Damned If You Don't: Religious Shunning and the Free Exercise Clause*, 137 U. PA. L. REV. 271, 272 n.5 (1988) (citing J. HOSTETLER, AMISH SOCIETY 63 (1963)).

311 See generally *id.* at 273 n.6, for a discussion of cases in which the spouse of the shunned person is encouraged to leave or shun the latter in accordance with church doctrine.

312 *See* Bear v. Reformed Mennonite Church, 341 A.2d 105, 106 (Pa. 1975).

313 See generally Miller, *supra* note 310, at 273 n.8, for a discussion of cases in which shunning caused damage to the shunned person's reputation and business relationships.

For communities that operate outside the framework of mainstream society, the threat of ostracism functions as the equivalent of state law. Without this threat, the group's ability to discipline its members would be rendered ineffective. At the same time, however, the norm of shunning, if excessively practiced, may collide with some other legitimate state interest. Courts faced with a collision of competing norms have had to balance the state's interests against the free exercise claims of the religious group.[314] In *Paul v. Watchtower Bible & Tract Society of New York*,[315] the Ninth Circuit upheld the right of Jehovah's Witnesses to engage in the practice of shunning ex-members against an ex-member's common law claims of defamation, fraud, and outrageous conduct because of the Free Exercise Clause of the First Amendment and because "the practice of shunning [did] not . . . constitute a sufficient threat to the peace, safety, or morality of the community as to warrant state intervention."[316]

A different conclusion was reached in *Bear v. Reformed Mennonite Church*.[317] The plaintiff alleged that after his excommunication from the church for criticizing church teachings and practices, he was severely shunned by the church. As a result, his business, as well as his marriage, suffered because shunning, as practiced by the church, involved complete boycotting by church members, including his business associates and his wife and children. The court found that the complaint presented sufficient facts to raise the question of whether shunning as practiced by the church could be considered "an excessive interference within areas of 'paramount state concern,' i.e. the maintenance of marriage and family relationship, alienation of affection, and the tortious interference with a business relationship . . . even in light of the 'Establishment' and 'Free Exercise' clauses of the First Amendment."[318]

The relevant interests, of course, are not the same in rotating credit associations or other nonreligious communities.[319] There is no constitutional privilege to balance against the state's interest in pro-

314 For a discussion and analysis of cases dealing with religious shunning, see *id.*

315 819 F.2d 875 (9th Cir. 1987).

316 *Id.* at 883.

317 341 A.2d 105 (Pa. 1975).

318 *Id.* at 107.

319 Professor Cooter pointed out that religious communities such as the Amish are "ultimate communities" whereas business people form "instrumental communities." *See* Cooter, *supra* note 2, at 1686. Rotating credit associations fall somewhere between the two. The associations themselves are not insular "ultimate" communities but are community markets embedded within culturally homogenous communities. For purely business communities, "two natural limits on coercion of individuals by communities" exist: the exit option and the mobility option. *See id.*

viding a cause of action, if its underlying elements are met, for a given tort. But there is, nonetheless, a case of competing interests between the claims of community and state. On the one hand, the existence and viability of any community that is marginal—culturally, religiously, or economically—vis-a-vis society at large depend to a significant degree on its cohesiveness. Cohesiveness depends in turn on the community's ability to foster a group-based sense of unity balanced against the individual's fear of being forced outside the embrace of the group. The possibility that sanctions will be meted out for conduct that breaches community norms must be real enough to deter actual breaches; at the same time, the costs inflicted on those who deviate must be sufficiently severe to counteract defection.

Without the threat of state law, the threat of shunning—the severance of social and economic ties with the community—plays an important part in keeping members within the bounds of community norms. While shunning is not the only means of ensuring compliance (shame and guilt also play a part), it is an effective one. In some Korean-American communities, "defaulting would make it nearly impossible to get a job among Korean Americans or even a marriage partner."[320] This may be so not because of any orchestrated campaign by community leaders to shun or to pressure others into shunning the defaulting person. It may be so simply because a person who defaults is judged by others to be untrustworthy, and an untrustworthy person is not anyone's first choice for a business or marriage partner.[321]

> Through mobility, an individual can escape coercion by one community and find another community that is more congenial. In contrast, the creation of a mass society through the destruction of communities reduces the alternatives available to everyone. The limits of self-help should be assessed before a court grants a legal remedy to an individual who feels repressed by his community.

Id. The option of exit for a shunned member of a rotating credit association will depend on the insularity of an ethnic community and the extent to which a member feels culturally, economically, and psychologically bound to that particular ethnic community.

320 Jordan Rappaport, *The Korean Example*, NEW DEMOCRAT, May 1992, at 22.

321 *See* Gruter, *supra* note 309, at 271–79. "Ostracism" may exist even without the affirmative practice of active shunning. Andrew Yoder, who had left the Amish church and purchased a car, sued several officials of the Amish Church for violating his right of religious freedom and exacerbating his stomach ulcers when it ordered its members to shun him. The jury awarded him monetary damages, and the judge ordered church officials to lift the shunning order. To satisfy the monetary judgment in Yoder's favor, the sheriff seized the property of one of the church officials. Eventually, church officials removed the ban. Yoder remained isolated from the community, however, even after the removal and reversal of the church's shunning order. *See id.*

It is unlikely that the latter instance would give rise to any cause of action. On the other hand, activities, even those motivated by religious beliefs, that rise to the level of harassment, intimidation, or threats may be sufficiently excessive or outrageous to provide the plaintiff with a cause of action under the relevant state law.[322] In those cases, the court would have to make a case-by-case determination, balancing the particular norms of the community against other areas of paramount state concern. In *Lide v. Miller*,[323] a dentist sued church elders for libel, slander, and tortious interference with his business relations when the elders proclaimed the plaintiff's misconduct to the congregation, causing harm to his reputation and dental practice. The court of appeals overturned a lower court's grant of summary judgment in favor of the church and remanded the case for trial upon the merits on the grounds that, although "civil courts have no jurisdiction over and no concern with, purely ecclesiastical questions and controversies, they do have jurisdiction as to civil, contract and property rights even though such rights are involved in, or arise from, a church controversy."[324] According to the court, the alleged libelous and slanderous communications should have been subject to more scrutiny at the trial level.

This approach, if transposed into the rotating credit association context, may be a workable middle ground that allows the court to enforce the parties' "no law" understanding and defer to the group's norms on matters directly within the core of the association's activities, for example, those involving how much or when contributions should be made, how priority drawings are determined by the group—whether by lottery, by rotation, or by interest bidding—whether and under what circumstances collateral may be required, and whether and to what extent the organizer is or is not jointly and severally liable in a case of default by a participant. Other matters that are not directly related to the issues of saving and lending, even if they arise from the association's activities, may be examined by the court if they touch upon some area of paramount state concern, such as the state's interest in providing a cause of action for common law defamation.

322 *See* Carrieri v. Bush, 419 P.2d 132, 137 (Wash. 1966) (holding that although the church members' acts, done in furtherance of their religious belief, would be constitutionally privileged under the facts of the case, the privilege was nullified when the church caused ill will, intimidation, and threats to be issued against the plaintiff and caused plaintiff's wife to leave him because she was persistently told her husband was a devil).

323 573 S.W.2d 614 (Tex. Civ. App. 1978, no writ).

324 *Id.* at 615 (citations omitted).

In sum, my proposal for this Part of the Article can be restated in the following way: for reasons discussed above, where norms are socially beneficial—for example, norms that advance the virtues of community as well as the production of social capital and further the economic viability of marginal groups—the state should respect and promote them. Rotating credit associations represent one instance of community market formation and community participation and empowerment despite impediments caused by open market imperfections. The norms of trust and reciprocity that further community exchanges and allow transaction costs to be lowered can best be promoted by a "hands off" posture described above. Judicial interference in most instances will result in the erosion of community and informality in favor of a more formal contractual regime. Imposing a contractual regime of formal transactions on informal credit associations would be too costly, from both a transaction and a litigation standpoint, given the costs of gathering information, screening potential applicants, drafting contracts, monitoring the performance of borrowers, and litigation costs, as well as the uncertainty of recovery.[325] Additionally, requiring adherence to formality would simply replicate the concomitant costs that already deter financial institutions in the formal economy from providing credit to low-income communities.

Additionally, and perhaps most significantly, open market alternatives are not available, which is why it is all the more important for courts to allow the community to operate on and draw from community norms without the threat that the formality of state law will infect the community's social capital base. While certain private regimes of trade, for example, the predominantly Orthodox Jewish diamond industry in New York, "ha[ve] systematically rejected state-created law"[326] by subjecting all transactions to a private order of industry norms and usage, rotating credit associations have emerged not by choice but by necessity—not only to lower costs behind a transaction but also to remove barriers that discourage actors acting from a rational cost-benefit basis from entering into the transaction in the first place. In other words, rotating credit associations exist not simply to lower the transaction costs of an *existing* market. They represent, rather, an example of a community market that emerges precisely because the transaction at issue—lending to lower-income borrowers—is in many instances not viable on the open market. The situation they present, then, is not only one of lowering transaction costs in order to

325 *See generally* Bernstein, *Opting Out*, supra note 97, at 132–38.

326 *Id.* at 115.

make transactions more efficient, but rather one of lowering transaction costs in order to allow a market to emerge.

B. Linkages Between Markets

Aside from whether courts or legislators should defer to private norms, there is also the issue of private lawmaking by rotating credit associations and whether and to what extent it can be replicated in the open market.[327] In this Section, I examine whether or not linkages between the open market and the community market can or should be introduced. For example, which structural features of rotating credit associations provide their comparative advantage, and how can they be transferred to and simulated by the formal lending sector?

Spurred by the high success rate of rotating credit associations, ethnic banks, in fact, have been more willing to evaluate creditworthiness by resorting to criteria other than mere credit history. Korean-owned banks are beginning to adopt some of the criteria used by rotating credit associations and emphasize social rather than economic collateral—for example, peer pressure, family connections, community, and identity[328]—as a low-cost screening and monitoring mechanism. Also, banks in Los Angeles' Koreatown, in particular, have begun to emulate the structural incentives of rotating credit associations. Hanmi Bank, a Korean-owned bank, allows depositors who enter into a ten- or twelve-month $10,000 savings plan to be eligible for a lump sum advance of the entire $10,000 after three or four months of savings.[329]

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327 Professor Avery Katz noted that not enough investment has been placed on the study of "trade association rules, not for the purpose of advising courts and legislators whether to defer to such rules, but for the purpose of helping other trade associations decide whether to imitate them or instead to draft their own new forms." Katz, *supra* note 19, at 1757.

328 According to Benjamin Hong, Chief Executive Officer of Hanmi Bank, a Korean-owned, state-chartered bank, Hanmi Bank considers the applicant's "brothers, his uncles, his parents, and his families, of course, and . . . what kind of church he goes to, what kind of association he belongs to." *ABC News* (ABC television broadcast, Sept. 13, 1992) (transcript on file with *Notre Dame Law Review*).

329 *See* Schifrin, *supra* note 131, at 92; *see also* Frantz, *supra* note 301, at 1 ("Under a plan introduced . . . by Hanmi Bank, a customer who agrees to save $1,000 a month for 10 months can borrow $10,000 from the bank at the end of three months. The customer continues to collect interest on the savings while paying off the loan's principal and interest."); Reinhold, *supra* note 301, at 4 ("The would-be borrower agrees to deposit, for example, $100,000 over 24 months. After three or four months, he becomes eligible to borrow the full $100,000 at 2.5 points above the prime rate . . . ."); Arax, *supra* note 131, at 1 (noting that Hanmi bank allows customers who agree to save $1,000 a month for 10 months to borrow $10,000 after the end of the third

Under such a kye-like program, depositors typically determine their total savings plan amount and are permitted to take out a loan up to that amount once deposits equal one-third of the total plan.[330] Hanmi's kye-like Business Installment Plan, in addition, allows business customers who have deposited their full amount to take out additional loans for the total plan amount, even if money set aside under the plan has been withdrawn.[331]

Entities similar to a rotating credit association may be organized directly by a bank. As Michael Cunningham, president of Creative Investment Research described it, "[m]embers from inner-city neighborhoods would contribute to a bank account each month until the pool reached sufficient size. Then the bank would lend to one of the members, using the pool as collateral. If the borrower defaulted, the remaining members would have to cover the short fall."[332] Presumably, for the arrangement to benefit the borrower, the loan amount extended by the bank would have to be greater than the members' aggregate savings account. Like the traditional rotating credit association, the size of each credit pool would also be commensurate with the credit needs of the individual members.[333] Hanmi Bank also planned to institute other plans modeled even more closely after the kye. Under these plans, groups of up to ten members could obtain loans from the bank, based on joint guarantees from members of the group.[334] Like a kye, the group members would function as mutual monitors, screeners, and enforcers and thus allow the bank to significantly reduce its transaction costs. Hanmi Bank "is trying to tap the more traditional needs of its customers by bringing the kyes out of the

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month). Hanmi Bank was founded in 1982 by Korean businesspeople to serve the Korean American population whom the bank's founders believed were not getting adequate services from conventional, mainstream banks. *See Community Bank's Hard Work Raises CRA Grade*, THE REGULATORY COMPLIANCE WATCH, July 25, 1994, at 2.

330 *See Appeal of Savings Plans is Growing*, A.B.A. BANKING J., Sept. 1991, at 51.

331 *See id.* Other forced savings plans also operate under principles modeled after the kye. Peterson Bank of Chicago allows customers to determine the total plan amount and the increments for each installment. Once half of the planned amount has been deposited, customers are allowed to withdraw from their accounts without penalty. *See id.*

332 Elyssa Getreu, *Taking a Lesson from Korea for Lending in the Inner City*, AM. BANKER, June 29, 1992, at 7.

333 However, according to Michael Cunningham, while the "kye concept works for Koreans because they 'have a strong cash flow to begin with,' . . . [t]he savings habits of other minorities might be an impediment to his version of the program." *Id.* (citation omitted).

334 *See* Franz, *supra* note 301, at A1.

restaurants and into the bank,"[335] in other words, through linkages between the open and the community markets.

Concepts such as mutual monitoring and joint liability that govern rotating credit associations can be introduced to increase the likelihood of repayment in other contexts as well. Under this concept, the pool may be guaranteed by a third party entity such as the Small Business Administration.[336] This structure would allow the bank to sell the loan portfolio on the secondary market and hence increase its capital pool for additional lending,[337] and it would at the same time encourage microloans—small loans to borrowers who cannot meet the collateral requirement and other criteria of creditworthiness demanded by banks.

Another way of introducing the concept of mutual monitoring so crucial to the success of rotating credit associations is to adopt a lending method used by the Grameen Bank of Bangladesh.[338] Grameen Bank's "lending circle," which uses joint liability to ensure mutual monitoring among the circle's members, is similar in concept to that used in rotating credit associations. The circle consists of five members, and lending is made on the basis of a "two, two, one" scheme. The bank lends to two members of the group first. Then, upon satisfaction of the loan, the bank lends to two additional members, and finally the fifth. The group's members act as coguarantors. Additionally, should one member prove to be delinquent, her action would jeopardize the entire group's eligibility for loans from the bank.[339] As a result, "because it is the group—not the bank—that initially evalu-

335 *Id.*

336 Although once a record of creditworthiness is established, the pool itself, rather than a government entity, can serve as security for additional loans by the bank.

337 *See* Getreu, *supra* note 332, at 7; *see also* Lewis D. Solomon, *Microenterprise: Human Reconstruction in America's Inner Cities*, 15 HARV. J.L. & PUB. POL'Y 191, 217 (1992). For a discussion of microenterprises, see *id.*

338 The Grameen Bank was founded for the express purpose of offering "poor people credit without collateral." Mohammad A. Auwal, *Promoting Microcapitalism in the Service of the Poor: The Grameen Model and Its Cross-Cultural Adaptation*, 33 J. BUS. COMM. 27 (1996). *See also* THE GRAMEEN READER: TRAINING MATERIALS FOR THE INTERNATIONAL REPLICATION OF THE GRAMEEN BANK FINANCIAL SYSTEM FOR REDUCTION OF RURAL POVERTY (David S. Gibbons ed., 1992).

339 The difference between the Grameen Bank or other similar lending circles and rotating credit associations is that in the former, borrowers borrow from a third-party entity—a bank—whereas in the latter, borrowers in essence borrow from themselves and must rely on their own savings.

ates loan proposals,"[340] and because "[d]efaulters spoil things for everybody else, . . . group members choose their partners wisely."[341]

These approaches would reduce the problem of information asymmetry and would allow banks to lower the transaction costs of screening, monitoring, and enforcement. They would also introduce the concept of joint liability described in Part III[342] and make it possible for banks to rely on the bottom-up mutual monitoring and enforcement mechanisms of the rotating credit associations.

One can argue that preferences for rotating credit associations are unnecessary because they are merely variants of existing institutions, such as community development banks.[343] The latter, however, cannot act as substitutes for rotating credit associations. They are too institutionalized and too formal to achieve the comparative advantage offered by community rotating credit associations. The forty or so microbanker funds[344] in the United States, heavily supported by foundations,[345] "have yet to develop a systematic, self-sustaining methodology."[346] Due to the prevalence of below-market-rate loans to poor

340 Bornstein, supra note 177, at 40.

341 *Id.*

342 *See supra* notes 210–16 and accompanying text.

343 JULIA ANN PARZEN & MICHAEL HALL KIESCHNICK, CREDIT WHERE IT'S DUE 15 (1992) ("Financial institutions created primarily to foster economic development are development banks. As financial institutions, they work to conserve their capital; as development vehicles, they seek to contribute to economic development."). Community development banks have sought to emulate rotating credit associations by adopting the informal peer-group "lending circle" approach to lower their risk of lending. Like commercial banks, they are chartered and regulated as insured depository institutions and at the same time are designed to fulfill social and development objectives in addition to commercial objectives.

344 Microenterprise programs, which provide small loans from $500 to $25,000, are usually accessed through community development banks. *See* Susan R. Jones, *Small Business and Community Economic Development: Transactional Lawyering for Social Change and Economic Justice,* 4 CLINICAL L. REV. 195, 197 (1997). A microenterprise is defined as "'a sole proprietorship, partnership or family business that has fewer than five employees, does not generally have access to the commercial banking sector and can initially utilize a loan under $15,000." *Id.* at 197 n.3 (citation omitted).

345 *See* Kenneth H. Bacon, *Clinton Looks to a Bank in Bangladesh for Model to Help U.S. Poor Get Loans,* WALL ST. J., Aug. 27, 1993, at A2.

346 Bornstein, *supra* note 177, at 40. Other studies have claimed approximately one hundred microloan funds in the United States. Most use the peer monitoring method and substitute traditional collateral requirement with social collateral. Such funds include the Southern Development Bankcorp, a community development bank in Arkansas which operates the Good Faith Fund, the Lakota Fund on the Pine Ridge Indian Reservation in South Dakota, the Women's Self-Employment Project in Chicago. The success rates of the microloan funds have been mixed. Administrative costs of counseling and educating potential borrowers, as well as training the banks'

borrowers, the high administrative costs—namely operating costs, employee salaries, office space, travel, training, promotion, and other professional services, as well as costs of processing small loans—"no microenterprise lender in the United States has come close to breaking even, and only a handful have more than a few hundred borrowers."[347] Profits earned by South Shore Bank in Chicago, for example, are used to support activities by other developmental agencies associated with the Shorebank Corporation, and even though such activities may be socially useful, they may also be "littered with barriers and risks."[348] Even the most ardent supporters admit that "[s]elf-sufficiency in development banking . . . is the exception rather than the rule. Development banks whose goal it is to redistribute wealth or to address problems in very-low-income communities have generally relied on large and ongoing subsidies to continue."[349]

By contrast, rotating credit associations, which operate on a much smaller scale than development banks, provide an additional benefit for members by acting as community deposit institutions that are completely self-sustaining and self-funding. Because capitalization for the association comes from the members themselves, rotating credit associations perform the necessary function of community savings mobilization. Loans come only from the members' own contributions and, as a result, rotating credit associations "force people who aren't too disciplined into saving the money."[350]

In many ways, then, while the formal public sector can promote and preserve the community in which rotating credit associations operate—by adopting an adjudicative philosophy that defers to community norms when appropriate—there are also limits to the kinds of linkages that can be forged between the formal and the community economies of credit. Although state-subsidized entities, such as com-

staff in community development, are high. The amount required to run the Women's Self-Employment Group, for example, is greater than the amount actually loaned to borrowers. *See* Aruna Srinivasan, *Intervention in Credit Markets and Development Lending*, FED. RESERVE BANK OF ATLANTA ECON. REV., May–June 1994, at 13, 22.

347 Borstein, *supra* note 177, at 40; PARZEN & KIESCHNICK, *supra* note 343, at 115–29.

348 PARZEN & KIESCHNICK, *supra* note 343, at 116. The Shorebank Corporation in Chicago, for example, is an umbrella organization that includes a community development bank, a for-profit real estate subsidiary, and a nonprofit training company. Most development banks, however, cannot survive on its members' savings alone but rather must be funded by grants from religious organizations, foundations, corporations, and state or local governments. These shareholders have not received nor do they expect to receive dividends.

349 *Id.*

350 Reich, *supra* note 302, at 1

munity development banks, may succeed in emulating some of the benefits of rotating credit associations, the very involvement of the state itself may result in a distortion of the particular mix of community, informality, and flexibility that gives such entities their greatest comparative advantage.

CONCLUSION

It is now commonplace for market proponents to defend the morality and efficiency of markets by reference to individual freedom and allocative efficiency. At the top of the list of the market's virtues is its respect for individual freedom through market interactions "to affirm existing values, to contribute to their further growth and to earn moral merit."[351] Economic freedom is "an indispensable condition of all other freedom, and free enterprise both a necessary condition and a consequence of personal freedom."[352] Markets are also defensible because they maximize the efficient allocation of resources. Each individual's freedom to further her own materialist impulses results in the maximization of individual and societal wealth.[353]

In recent years, however, the reascendant interest in community has led to an intense examination of the social values and virtues that are not easily produced by the market or, as some communitarian critics of the market claim, are even crowded out and harmed by the market.[354] These critics question the claim of market advocates that the market is nonjudgmental because it allocates goods and services only in accordance with consumer demand without questioning or defining such preferences. Indeed, market goals of wealth maximization and economic efficiency, critics argue, are tautological: the market produces whatever consumers value, but the very production of consumer value is itself determined by the market.[355] At least three conclusions can be drawn from this critique of the market. First, the market is not simply a neutral mechanism for maximizing ends whose natures and origins are exogenous to the market. Second, the teleology of the market has led to the triumph of market values that glorify self-interested behaviors and market competition over other nonmarket values that promote civic virtues and the collective good.

351 F.A. Hayek, *The Moral Element in Free Enterprise, in* STUDIES IN PHILOSOPHY, POLITICS AND ECONOMICS 229–30 (1967).

352 *Id.* at 229.

353 *See generally* Posner, *supra* note 62.

354 *See* SANDEL, *supra* note 290.

355 *See, e.g.*, Mark Kelman, *Consumption Theory, Production Theory, and Ideology in the Coase Theorem*, 52 S. CAL. L. REV. 669 (1979); Arthur Allen Leff, *Economic Analysis of Law: Some Realism About Nominalism*, 60 VA. L. REV. 451 (1974).

And third, market ideology itself is detrimental to the maintenance and promotion of community because it promotes a naked view of the individual as autonomous and socially atomized.

This Article has looked at the intersection of market and community to explore how both converge without one promoting preferences that run counter to the other's. Rather, I have shown that community norms of cooperation and commitment to the common good deter naked self-interested behaviors and can produce the very efficiency and wealth-producing effect that the market favors. In this respect, the interaction of market and community reinforces the wealth maximization potential of markets and the collective bonds of community by aggregating, through the community market, the interests of the individual and the group to remedy imperfections neither the state nor the open market could solve.

As I have demonstrated, while laws against discriminating and redlining exist, they cannot fully address the problem of rational discrimination and, in particular, rational redlining, as banks believe that the economic costs of lending in low-income communities far outweigh the benefits. Given the screening, monitoring, and enforcement costs incurred, the administrative burden of overseeing relatively small loans that may come without collateral and other usual indicia of creditworthiness is often too costly to make traditional lending economically worthwhile. Without the information exchange mechanisms available to rotating credit associations to lower the costs of screening, monitoring, and enforcing loans, banks subscribe instead to wholly different standards in their evaluation of creditworthiness. Despite the pressure exerted on banks by the passage of the ECOA and the CRA, the public law model faces limitations that are difficult to overcome without more radical intervention by the state. From a rational, cost-benefit perspective, the open market is not capable of solving the problem of credit rationing and adverse selection that banks face.

I have argued in this Article that formal public lawmaking should be supplemented by informal private lawmaking and that the state should favor supplementation of open market contracts with community market contracts, where people opt into relational and status arrangements. In rotating credit associations, communities rely on self-enforcing norms to regulate and solve their community credit problem. By subscribing to the community's production of norms and practices to enforce credit contracts, rotating credit associations draw on their members' social capital base of identity and trust and their respective "reputational bonds" to create a systematic but private ordering of economic relations that manage to overcome the informa-

tional and incentive barriers facing financial institutions in the formal sector.

Largely outside the formal, state-created legal system, rotating credit associations nonetheless induce a high level of compliance from members whose internalization of community norms allows the associations to engage in low-cost screening, monitoring, and enforcement of the community's credit terms. This Article draws from and builds on works in psychology and sociology to investigate how constructs of identity, community, and trust affect rational economic behaviors, and in the process perform a welfare-enhancing role by expanding the availability of credit for those borrowers ineligible for credit in the formal economy. In this respect, the Article demonstrates that a community of shared vocabulary about rights and expectations facilitates economic exchanges among members. To this extent, the discourse on communitarian values has an economic efficiency benefit that has been neglected in the debate on communitarianism.

At the same time, however, I recognize that not all norms are wealth-maximizing or socially beneficial, and thus not all norms should be enforced or promoted by the state. Members of a rotating credit association and the association itself share a common aggregation of interests so that the incentive structure of the group contains built-in institutional arrangements that serve to stem force and coercion. When the production of norms emerges from an incentive structure that promotes cooperation, minimizes the risk of appropriation, and produces, without negative economic spillover, economic efficiency by correcting the deficiencies of the open market, a strong argument exists that the state should have the discretion to support such norms and the entities that promote them.

"The accumulation of social capital . . . is a complicated and in many ways mysterious cultural process. While governments can enact policies that have the effect of depleting social capital, they have great difficulties understanding how to build it up again."[356] The key is to forge the right balance needed to induce and maintain linkages between the public, open market and the community-based market in a way that promotes norms that are economically efficient, socially beneficial, and thus worth preserving.

356 FUKUYAMA, *supra* note 6, at 11.