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PRIVATE COMMERCIAL LAW IN THE COTTON INDUSTRY: CREATING COOPERATION THROUGH RULES, NORMS, AND INSTITUTIONS

*Lisa Bernstein**

The cotton industry has almost entirely opted out of the public legal system, replacing it with one of the oldest and most complex systems of private commercial law.¹ Most contracts for the purchase and sale of domestic cotton, between merchants or between merchants and mills, are neither consummated under the Uniform Commercial Code (“Code”) nor interpreted and enforced in court when disputes arise. Rather, most such contracts are concluded under one of several privately drafted sets of contract default rules and are subject to arbitration in one of several merchant tribunals. Similarly, most international sales of cotton are governed neither by state-supplied legal rules nor

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1. For an overview of the origins of the cotton industry’s private legal system, see A.W. Brian Simpson, *Contracts for Cotton to Arrive: The Case of the Two Ships Peerless*, 11 CARDOZO L. REV. 287, 293-314, 321 (1989).

by the Convention on the International Sale of Goods, but rather by the rules of the Liverpool Cotton Association.²

The institutions that create and administer the industry's private legal system work extraordinarily well. The trade rules are periodically revised to respond to technological advancements, market changes, and ambiguities revealed during disputes. Their content is known and understood by most market participants. The arbitration tribunals that resolve disputes do so expeditiously and inexpensively. Their decisions, which are recorded in written opinions, reveal a distinctive and coherent jurisprudential approach. Within the industry, arbitration awards are widely respected and complied with promptly. In short, the industry has succeeded in creating and maintaining a private legal system ("PLS") in which transactions costs, error costs, legal system costs, and collection costs are low. This system has endured since the mid-1800s, surviving widespread social change, years of extreme price volatility, and substantial changes in the background public legal regime.

This Article draws on a detailed case study of contractual relations in the cotton industry to examine the ways that the rules, norms, and institutions that constitute the industry's PLS create value for transactors. Part I describes the formal operation of the PLS and discusses the ways that its substantive rules, adjudicative approaches, and arbitral procedures improve on those provided by the Code and the public legal system. Part II describes the many steps taken by cotton industry institutions to strengthen the social and informational infrastructures of trade. It discusses how these efforts combine to make reputation-based nonlegal sanctions a powerful force in the industry and explores how the availability of these sanctions makes important features of the PLS work better than they would in their absence. It also suggests that the availability of such sanctions may enable transactors to create value-enhancing contract governance structures that might be either unavailable or prohibitively expensive if their transactions were governed by the public legal system. Part III takes a step back and explores how the industry's efforts to support the legal and extralegal aspects of contracting relationships, together with certain other features of cotton institutions, have succeeded in creating conditions that are conducive to the creation, maintenance, and restoration of cooperative contracting relationships. Part IV concludes by suggesting that understanding how the cotton industry's institutions create value for transactors may help identify other industries and other contexts in which private institutions can play a positive role in supporting trade.

2. Email from Linda Mawdsley, Membership Manager, Liverpool Cotton Exchange, to author (Oct. 27, 1997) (noting that the Liverpool Cotton Association trading rules govern approximately fifty percent of international cotton contracts).

I. THE PRIVATE LEGAL SYSTEM

A. *The Formal Operation of the Private Legal System*

There are numerous sources of private commercial law in the domestic cash markets for the purchase and sale of cotton.³ Most merchant-to-mill transactions are governed by the Southern Mill Rules (“SMRs”),⁴ a set of trade rules that is jointly adopted by the American Cotton Shippers Association (“ACSA”),⁵ a trade association representing merchants, and the American Textile Manufacturers Institute (“ATMI”),⁶ a trade association representing mills.⁷ Most merchant-to-merchant transactions are governed by the trade rules of one of four regional cotton shippers’ associations, all of which are members of ACSA,⁸ or by the rules of the Memphis Cotton Exchange (“MCE”), whose ninety member firms typically “handle about 75 percent of the U.S. cotton trade and about 35 percent of the world’s cotton trade.”⁹

3. A cash market for a commodity is one in which the commodity is bought and sold — on any of a variety of payment terms — for *actual* delivery.

4. Minutes of the American Cotton Shippers Association/American Textile Manufacturers Institute Joint Meeting (1984) (75-80% of the cotton bought by United States mills is subject to the SMRs).

5. ACSA “is the spokesman for private cotton merchants of the United States.” Am. Cotton Shippers Ass’n, *Southern Mill Rules, in SOUTHERN MILL RULES FOR BUYING AND SELLING OF AMERICAN COTTON 2* (1996), available at http://www.acsa-cotton.org/About_ACSA/Search%20Rules/about_acsa.html [hereinafter SMRS]. This rulebook also includes the *Rules and Regulations of the Cotton States Arbitration Board* [hereinafter CSAB Rules] and an *Outline of Services Available for Quality Arbitrations By Cotton States Arbitration Board and Technical Arbitrations By the Board of Appeals Under Southern Mill Rules* [hereinafter *Outline of Services*]. *Id.*

6. The ATMI is the “trade association for manufacturers of textile mill products . . . [Its] members . . . process some 75 percent of all domestically grown cotton consumed annually in the United States.” *Id.*

7. The ACSA and ATMI rules committees meet together at least once a year to consider revising the SMRs. However, because the associations’ interests are often antagonistic, and amendments must also be ratified by the membership of both organizations, the revision process is slow. See Letter from R. C. Dickerson, Executive Vice-President and Secretary of ACSA, to R. K. Vincent (January 21, 1952), in connection with SEAB Case No. 61 (“With regard to your suggestions about clarifying some of the Southern Mill Rules, beg to say that this is a long and tedious process . . . it is very difficult to secure any changes and it usually takes a couple of years at least before such changes can be effective.”).

8. These organizations are the Western Cotton Shippers Association (“WCSA”), the Atlantic Cotton Association (“ACA”), the Southern Cotton Association (“SCA”), and the Texas Cotton Association (“TCA”). A fifth organization, the Arkansas-Missouri Cotton Trade Association, existed as late as 1990 but is now defunct. Its former members were absorbed by the other regional associations. In the past, there were also numerous local and regional cotton exchanges. Today, with the exception of the Memphis and Greenwood Exchanges, most are either defunct or have greatly curtailed their activities.

9. Charles Conner, *Julien Fall Year Ago Changed Industry*, COM. APPEAL, Jan. 20, 1991, at C1.

Both shippers' associations and regional exchanges provide arbitration services.¹⁰ Most require members to arbitrate disputes with other members as a condition of membership.¹¹ In addition, the ACSA and the ATMI have created a joint arbitration tribunal, the Board of Appeals ("BoA"),¹² to arbitrate contract disputes that arise under the SMRs.¹³ They have also created a separate tribunal, the Cotton States Arbitration Board ("CSAB"), to make binding quality determinations.¹⁴ Although merchants and mills are not required to contract under the SMRs, or to arbitrate disputes with one another as a condition of membership in their respective trade associations, most merchant-to-mill contracts nevertheless provide for BoA arbitration.¹⁵

The formal operation of the cotton industry's PLS can best be understood by looking at the procedural rules, substantive rules, adjudicative approaches, and judgment enforcement mechanisms that have been adopted by the two most important private commercial law institutions in the domestic cash cotton trade:¹⁶ the BoA, which resolves

10. A modest fee is charged for these services, *see* MEMPHIS COTTON EXCHANGE BY-LAWS, Art. IV, § 9 (1993) [hereinafter MCE BY-LAWS] (providing that "[i]n all cases of Arbitration concerning cotton, the charges shall be as determined by the Board of Directors").

11. *See, e.g., id.* at Art. IV, § 8 ("Any member refusing to submit to an arbitration when asked for by another member or a nonmember, providing the Arbitration Committee consider [sic] there exist good grounds for an arbitration, or to abide by any award or decision of said Committee when rendered," may be expelled from the Exchange).

12. In earlier years, these organizations sponsored two sets of trade rules and two arbitration boards. One of these boards, the New England Board of Appeals ("NEBoA"), resolved disputes in the New England region. The other, the South Eastern Appeal Board ("SEAB"), resolved disputes in the Southern region. Today, the Board of Appeals ("BoA"), sometimes referred to as the "Southeastern Appeal Board," uses the Southern Mill Rules to resolve all disputes regardless of where in the country they arise. Am. Cotton Shippers Ass'n, *Outline of Services, supra* note 5. Although these tribunals are referred to as "appeals" boards, they are tribunals of first instance.

13. The BoA requires each litigant who is a member of ACSA or ATMI to pay a filing fee of \$400 per case, but refunds the fee to the prevailing party. When cases are filed by nonmembers or their attorneys, a fee of the larger of \$800 or the actual cost of the arbitration is charged. *Id.* at 38.

14. *See* SMRs, *supra* note 5, at Art. XI, § 43 (authorizing the CSAB — which is supervised by representatives of both ATMI and ACSA — to arbitrate quality disputes between shippers and mills). In 1972, however, "[t]he Executive Committee [of the CSAB] made arrangements with the Board of Supervising Cotton Examiners . . . now the Quality Control Section, of the U.S. Department of Agriculture in Memphis, to perform [quality] arbitration services for the industry." *Outline of Services, supra* note 5, at 34.

15. *Supra* note 4. This is usually achieved by incorporating the SMRs into the contract.

16. The importance of these institutions is suggested by, among other things, the fact that the MCE Trading Rules and By-Laws, the SMRs and BoA procedures, and the trading and arbitration rules of the Liverpool Cotton Association are an important focus of the curriculum at the educational institute for new industry participants held at Rhodes College each summer. *See infra* note 224 and accompanying text.

disputes between merchants and mills, and the MCE arbitration tribunal,¹⁷ which resolves disputes primarily between merchants.

1. *Procedural Rules*

The BoA is composed of one arbitrator appointed by the president of the ATMI and one appointed by the president of the ACSA.¹⁸ Arbitrators are selected for their “experience in their respective industry and their reputation for integrity and fairness.”¹⁹ The BoA does not hold hearings. It decides cases solely on the basis of briefs and documentary evidence, most commonly: verified copies of confirmations, correspondence, mail receipts, telephone logs, weight slips, quality determination reports, and affidavits from lawyers and employees who played roles in the questioned transaction. All evidence has the names of the parties redacted.

The MCE arbitration tribunal is composed of seven arbitrators, appointed annually by the Exchange’s board of directors. It holds oral hearings,²⁰ complete with the calling of witnesses and cross-examination.²¹

17. Unless otherwise noted, the expression “MCE arbitration tribunal,” refers to the Exchange’s “regular standing Arbitration” tribunal. TRADING RULES OF THE MEMPHIS COTTON EXCHANGE, R. 34, cl. 2 [hereinafter MCE TR]. Since the early days of the exchange, this tribunal has handled disputes between members, between members and nonmembers, and even, on occasion, disputes between two nonmembers. In 1995, however, in an attempt to create a public perception of fairness, the MCE established a separate tribunal for disputes involving nonmembers. This tribunal operates under its own, somewhat different procedural rules. The arbitration panel consists of three arbitrators, arbitrators are chosen by agreement of the parties, and there are no appeals. If the claim is for less than \$25,000 and the parties agree, only one arbitrator need hear the case. Nonbinding pre-arbitration mediation is also available if agreed to by the parties.

One of the more striking differences between regular MCE arbitrations and these special arbitrations is that the special tribunal’s procedures make it easier for parties to get information from one another. *See id.* at R. 43, cl. 4 (“Upon the request of any party to the arbitration made in writing with notice to the other party, the Chairman of the Rule 43 Arbitration Committee shall issue subpoenas as provided in the Federal Arbitration Act and/or the Tennessee Uniform Arbitration Act.”). This provision was considered undesirable by the MCE board but was adopted on the advice of a prominent industry attorney who told the board that it was needed in order to maintain the perception that the tribunal was fair to nonmembers. Telephone Interview with MCE Executive (Feb. 1997).

18. *See Outline of Services, supra* note 5, at 35. When the arbitrators do not agree, they are authorized to jointly appoint a third arbitrator. From 1975 to 1996, however, the BoA heard twenty-eight cases, none of which required the appointment of a third arbitrator. *See* BoA opinions 1975-1996.

19. *Outline of Services, supra* note 5, at 35.

20. *See, e.g.,* Case Record, MCE Case No. 832 (1985) (noting that multiple hearings were held); Letter from the MCE Vice-President and Secretary, to the Parties (March 11, 1985), in connection with MCE Case No. 832 (informing the parties that they will have to appear in front of the arbitration committee).

21. MCE arbitrators also take an active role in questioning the parties and witnesses. *See, e.g., Questions Reference*, typewritten sheets filed with the case record for MCE Case

Neither the BoA nor the MCE's arbitration tribunal permit unconstrained party-initiated discovery, though both permit the arbitrators to request additional information.²² The SMRs do not contain a general limitations period, but they do contain rules specifying the proper time frame for raising certain types of objections.²³ The MCE trading rules provide that all claims are to be reported to the arbitration committee "within thirty days after the matter in controversy arises,"²⁴ and also specify time frames for raising particular types of objections.²⁵

Both tribunals produce written opinions. Most opinions include a statement of the facts, a short discussion of the rule to be applied, a few paragraphs discussing the arbitrators' reasoning, and an award.²⁶ Some opinions, however, simply state the outcome of the case.²⁷ BoA

No. 835 (1991) (listing questions for the arbitrators to ask the parties); MCE Case No. 839 (1991) (revealing in the transcript that arbitrators questioned the parties).

22. See *Outline of Services*, *supra* note 5, at 36 (noting that the BoA can "ask either of the parties for additional information or clarification of statements made in their briefs"); see also Memorandum of the Arbitrators (Aug. 24, 1953), in connection with SEAB Case No. 71 (referring to a request for submission of additional information); Letter from ACSA Secretary to Arbitrator (Jan. 23, 1996), in connection with BoA Case No. 139 ("Should you require any further details pertaining to this case, please contact me and I'll make every effort to obtain the information requested"); Letter from Arbitrators to the CSAB Secretary (March 28, 1984), in connection with BoA Case No. 118 (requesting additional information); NEBoA Case No. 280 (1929) (declining to render a judgment pending submission of additional information); Letter from the MCE Executive Vice-President and Secretary, to the Plaintiff's Attorney (March 9, 1988), in connection with MCE Case No. 833 (requesting information about the nature of the plaintiff's business and additional documents).

23. See SMRs, *supra* note 5, at Art. VII, § 32 ("Claims for loss in weight or payment for gain in weight must be made within seven business days from receipt of the cotton, or of the last portion of the shipment."); *id.* at Art. VIII, § 36 ("Notice of claims for variations in invoice tare allowances must be given seller by buyer within twenty business days from receipt of cotton."); *id.* at Art. VIII, § 37 ("All claims for variations in invoice tare allowances must be filed within nine months from receipt of cotton."); *id.* at Art. IX, § 39 ("Claims as to quality must be made within ten business days from the date of the receipt of the last portion of the shipment except, where cotton is deliverable in monthly installments, the claims shall be based on each separate installment.").

24. MCE TR, *supra* note 17, at R. 34, cl. 1.

25. See *id.* at R. 5, cl. 5 ("[A]ny rejection for differences in grade and/or staple will only apply on cotton if it is shipped out of the point of origin or resampled within ninety (90) days from date of payment by Buyer."); *id.* at R. 18, cl. 1 ("[When cotton is rejected as being of nonstandard density], market difference is to be adjusted between Buyer and Seller provided a claim is made within 10 days from invoice date."); *id.* at R. 22, cl. 1 ("[R]eplacements must be made within ten days from date of rejections.").

26. BoA Case No. 135 (1992); BoA Case No. 117 (1983); BoA Case No. 121 (1985); MCE Case No. 839 (1991).

27. See, e.g., MCE Case No. 835 (1991) (stating only that "[t]he Arbitration Committee of the Memphis Cotton Exchange based on written evidence supplied by both parties as well as the oral testimony of both parties rules that [Defendant] is not entitled to carrying charges and [Plaintiff] is not entitled to penalties. This decision was the unanimous decision of this Arbitration Committee"); BoA Case No. 139 (1996); BoA Case No. 129 (1990). It is not entirely clear why the format of opinions is so variable. One BoA arbitrator explained that he was not an eloquent man, so when he wrote, the opinions were short, while his fellow arbitrator, with whom he served for many years, was a "wordsmith," educated at Yale (actually,

opinions are circulated to all ACSA and ATMI members.²⁸ The names of the parties are redacted,²⁹ but the names of the arbitrators are given. MCE opinions contain the names of both the parties and the arbitrators, but they are not made public. Neither tribunal formally accords prior decisions precedential authority.³⁰

a check of alumni rolls indicated it was Harvard), who liked to go on at length. Telephone Interview with Mill Representative #2, former BoA arbitrator (no date).

28. The ATMI and the ACSA keep BoA opinions, along with the briefs and evidence submitted, on file for inspection by their members. They occasionally receive requests for further information about cases or copies of the supporting papers. *See, e.g.*, Letter from the Chairman of the Board of [very large] Cotton Company to the ACSA Executive Secretary (June 19, 1967), in connection with BoA Case No. 98 (“I think there is something in the libel laws which prevents you from naming the buyer and the seller in this case, but I think it is proper for you to give the name of the seller on request and I do hereby request that you give us the name of the seller who refuses to be bound by a trade arbitration because an Act of God (crop failure) makes it impossible for him to deliver what another seller has offered to deliver at 8¢ higher.”). Such requests are more common when the BoA’s opinion does not contain a clear description of the facts found and the reasoning used. Telephone Interview with ACSA Executive (no date); *see also* Entire SMR Case No. 130 Sent To Following Active Members Per [ACSA Executive], BoA Case No. 130 (Feb. 5, 1991) (noting that the entire record of the case was sent to thirty-three members who had requested it, most likely because the opinion was brief and unclear).

In earlier years, the associations routinely circulated briefs and supporting evidence with the opinions. *See, e.g.*, ACSA Series A-Circular Letter No. 41 (Dec. 21, 1951) (“We are enclosing herewith for your information and guidance copies of briefs and summary of question [sic] submitted together with decision and minority report in Southeastern Appeals Board Case No. 62. This case is rather involved, but we recommend that it be studied carefully by all shippers to domestic mills.”). Although the reasons for this practice are unclear, giving transactors access to the same information as the tribunal makes it easier for them to determine whether the tribunal was impartial. Establishing its impartiality might have been especially important to the BoA, which resolves disputes between defined groups of market participants with often conflicting interests. Today, these supporting materials are only circulated in exceptional circumstances. *See, e.g.*, ACSA Series A-Circular No. 96 (Feb. 25, 1987), addressing BoA Case No. 124 (noting that in addition to the opinion, the association was “also enclosing ‘Seller’s Statement of Facts’ and ‘Seller’s Argument and Brief.’ Supporting documents on pages 15-17 are also provided. We did not deem intervening documentation necessary for reproduction”).

29. Although in important BoA cases, parties’ identities become quickly known through gossip, Telephone Interview with ACSA Executive (June 1996); *infra* note 172, the nonpublication of names may nevertheless be desirable from the perspective of industry insiders. BoA opinions often contain information indicating that a firm may be on the verge of financial distress (but not yet within the legal preference period). The practice of not revealing names keeps this information from industry outsiders — such as railroads, truckers, and insurance companies — for as long as possible, while the industry’s well-developed gossip networks help to spread it to industry insiders. *See infra* notes 124-129 and accompanying text (describing these networks). The practice may therefore enable insiders to better protect their positions with the distressed firm, by, for example, cashing out their position. *See SMRs, supra* note 5, at Art. XIX, § 56 (providing, in part that, “[i]f either party to the contract enters bankruptcy or admits insolvency, the other party may cancel the undelivered portion of the contract, with the market difference to be adjusted between the buyer and the seller, with one-half cent per pound penalty against the party in bankruptcy or admitting insolvency”).

30. In the past, BoA opinions sometimes mentioned prior opinions as persuasive or controlling authority. *See, e.g.*, NEBoA Case No. 181 (1924) (citing NEBoA Case No. 97 as controlling authority for the interpretation of Rule 61, defining “receipt of cotton”); NEBoA Case No. 187 (1924) (holding that NEBoA Case No. 60 governs). Arbitrators also occasion-

The BoA's awards are final judgments, but the MCE tribunal gives parties the right to appeal to a three-person appeals board in cases where the decision of the original panel was not unanimous.³¹ At the BoA, the rules require the time from filing to the close of evidence to be between fifteen and thirty days. Decisions are rendered as soon thereafter as possible.³² At the MCE, the length of time from filing to disposition varies but is typically just over a month.³³ Both the BoA and the MCE require prompt payment of awards.³⁴

2. Substantive Rules

The BoA decides contract disputes by applying the SMRs,³⁵ a comprehensive set of bright-line contract default rules³⁶ that cover

ally attempted to distinguish earlier cases. *See, e.g.*, NEBoA Case No. 276 (1929) (rejecting an argument based on an earlier decision, and explaining that the opinion cited, "was based on special circumstances and does not apply in this case"). However, references to prior cases gradually became less common and are quite rare today. One case explicitly repudiates the duty of the BoA to consider prior decisions. *See* SEAB Case No. 75 (1955) (noting that "[t]his Appeal Board has recently stated that it was not bound by previous decisions of the Board"). Nevertheless, the long service of certain individuals on the BoA ensures that there is some continuity in the tribunal's decisions. For example, from 1978-1996, the same ACSA representative served in seventeen of the twenty-seven cases decided by the BoA and the same ATMI representative served in fifteen of the cases.

Mention of prior decisions was even rarer at the MCE. From 1944-1991, only one MCE opinion mentions a prior case, and even there it is only mentioned because it was raised by one of the parties and the arbitrators give it no weight. *See* MCE Case No. 786 (1951).

31. MCE BY-LAWS, *supra* note 10, at Art. IV, § 5. From 1944 to 1991, only four of the ninety-two decisions rendered by the MCE arbitration tribunal were not unanimous. Of these four decisions, three were appealed. Two of the decisions were affirmed. *See* MCE App. Case No. 28 (1952); MCE App. Case No. 29 (1952). One of the decisions was reversed. *See* MCE App. Case No. 27 (1947). When an appeal is requested, the "party whose claim differs most from the final award" must pay the actual cost of the appeal. MCE BY-LAWS, *supra* note 10, at Art. V, § 3.

32. *Outline of Services, supra* note 5, at 36-38; MCE BY-LAWS, *supra* note 10, at Art. XV, § 3 ("Any claim [of indebtedness] allowed by the Arbitration Committee and remaining unpaid for ten days may then be pressed for immediate settlement by requesting same in writing to the Secretary . . . and five days shall be allowed for settlement.").

33. Based on information in the moving papers and opinions in all MCE cases decided from 1978-1991, the average time from filing to disposition was thirty-nine days. The longest case took eighty-four days, while the shortest took eleven days. Although the MCE Rules do not dictate a precise time frame for resolving a dispute, the fact that a defendant is given only three days to respond to a claim before the committee is permitted to hear the case *ex parte* suggests that the Exchange considers prompt dispositions important. MCE TR, *supra* note 17, at R. 34, cl. 1.

34. The MCE rules also attempt to ensure payment by requiring the defendant to post a pre-arbitration bond in the amount of the claim. MCE BY-LAWS, *supra* note 10, at Art. IV, § 4. In the past, strict compliance with the rule was enforced, but today bonds are not always required in practice. Telephone Interview with MCE Executive (no date).

35. The SMRs, however, "reserve [to the BoA] the privilege of refusing action on any dispute submitted if it feels the case at point has disagreements not involving SMR[s] or it does not have sufficient evidence to properly judge the issues." *Outline of Services, supra* note 5, at 35-36; *see also* ACSA, Series A-Circular Letter No. 40 (1953) (discussing this privilege). This privilege is occasionally exercised. *See, e.g.*, BoA Case No. 125 (1987) (de-

contract formation, performance, quality, delay, payment, repudiation, excuse, and damages, and include numerous industry-specific definitions of terms like “prompt,”³⁷ “raingrown,”³⁸ and “long staple.”³⁹ The MCE decides cases on the basis of the Exchange’s own Trading Rules,⁴⁰ which also define numerous industry-specific terms and contain primarily bright-line provisions. Although most SMRs and MCE Trading Rules would be enforceable under the Code if included in a contract,⁴¹ they nonetheless differ from the Code in fundamental ways.

First, the industry-drafted trade rules do not, for the most part, include the types of standard-like words, such as “reasonable,”⁴² “sea-

clining to issue a ruling without giving an explanation); SEAB Case No. 64 (1952) (same); BoA Case No. 115 (1981) (declining jurisdiction on the grounds that the BoA “should not act as a general referee or become an instrument for making general market determinations”); BoA Case No. 114 (1981) (“In the request for a Board of Appeals decision seller did not specify a rule section under which the Board of Appeals might concern itself. Further, the members of the Board of Appeals are not aware of any specific rule section which would appropriately apply to the dispute in question, under which it could determine an allowance as settlement . . . it would be improper for the Board of Appeals to render a decision in this case.”).

36. See SMRs, *supra* note 5, at Art. XVII, § 54 (“Buyer and seller shall have the privilege of incorporating any other rules, not in conflict with the spirit of the above rules, in their contracts.”).

37. *Id.* at Art. IV, § 16.

38. *Id.* at Art. III, § 13.

39. *Id.* at Art. III, § 10.

40. See MCE TR, *supra* note 17, at R. 2, cl. 1 (“These Trading Rules shall apply to all purchases and sales between members of the Memphis Cotton Exchange unless otherwise agreed in writing”). The MCE Trading Rules contain only two mandatory provisions. *Id.* at R. 31, cl. 1 (“Any exception to these rules can be made by mutual agreement at time of sale excepting Rule 1, Clause 4 and Rule 2.”); *id.* at R. 1, cl. 4 (“Both Buyer and Seller shall be primarily liable to each other for the fulfillment of all contracts.”).

41. Some trade rules, however, would be of questionable validity if included in a contract adjudicated under the Code. First, at times when cotton prices were very low, the trade rules that provide for the payment of a one-half cent per pound penalty might, if included in a contract subject to the Code, have been vulnerable to attack under U.C.C. § 2-718 (1991) and the relevant case law, on the grounds that they were invalid penalties since they were not a genuine attempt to pre-estimate damages. See, e.g., *Equitable Lumber Corp. v. IPA Land Dev. Corp.*, 344 N.E.2d 391 (N.Y. 1976). Today, however, these damage measures, if included in a contract subject to the Code, would most likely be enforceable, since their magnitude is insignificant given world cotton prices. Second, SMR Art. XIX, § 56, SMRs *supra* note 5, which provides that, “[i]f either party to the contract enters bankruptcy or admits insolvency, the other party may cancel the undelivered portion of the contract, with the market difference to be adjusted between the buyer and the seller, with one-half cent per pound penalty against the party in bankruptcy or admitting insolvency,” might be deemed an invalid ipso facto clause under the 1978 Bankruptcy Code.

42. The SMRs use the word “reasonable” once. See SMRs, *supra* note 5, at Art. XI, § 47 (requiring the buyer to “exercise all reasonable care of rejected bales”). The MCE Rules use it twice. See MCE TR, *supra* note 17, at R. 43, cl. 2 (requiring complaints filed in arbitration to be written “in reasonable detail”); *id.* at R. 5, cl. 5 (requiring claims of fraudulently packed cotton or false substitutions to be “presented within a reasonable length of time”). In addition, from 1944-1991, only one MCE opinion used the word “reasonable,” and the case was one that involved the proper time for making a claim for fraudulently packed bales, something the MCE rules explicitly state must be done within a “reasonable length of time.”

sonable,” and “without objection in the trade,” that permeate the Code. Rather, they contain primarily clear, bright-line rules.

Second, the types of damage measures available in the private system differ in important ways from the measures used in the public system. The Code’s damage measures are designed to protect the expectancy interest by putting the “aggrieved party . . . in as good a position as if the other party had fully performed.”⁴³ In contrast, the damage measures in the SMRs and the MCE Trading Rules tend to be under-compensatory.⁴⁴ Under the SMRs, the aggrieved party is entitled only to market difference damages plus a one-half cent per pound penalty (a penalty that is trivial given contemporary cotton prices).⁴⁵ The recovery of consequential damages is not permitted, although the SMRs do impose fixed fines for certain types of misbehavior.⁴⁶ The MCE uses the same measure for breach of contract,⁴⁷ and also imposes a variety of other fines such as per-day fines for delayed delivery⁴⁸ and late

Id.; MCE Case No. 760 (1945) (noting that “in reaching its decision [the arbitration panel] could find no evidence of fraudulent packing,” and that because the buyer had failed to inspect the cotton for six months, “the elapsed time cannot be termed ‘reasonable’ in this case for making a claim”).

43. U.C.C. § 1-106 (1991).

44. *See infra* note 135 and accompanying text (discussing the reasons that the market difference measure is under-compensatory, particularly in merchant-to-mill transactions).

45. SMRs, *supra* note 5, at Art. IV, § 18C. *See also* BoA Case No. 139 (1996) (where the buyer claimed \$158,500 in consequential damages in its brief, but this was not mentioned in the arbitrators’ opinion and no consequential damages of any kind were awarded). The SMRs further provide that the market price shall be determined from “three bona fide offers on the identical quality and with identical terms to that contracted,” given to the aggrieved party, and that “[a] buyer’s purchase [when the seller breaches] . . . shall be based on the lowest of the three offers. [While a] seller’s sale [when the buyer breaches] . . . shall be based on the highest of the three offers.” *Id.* In addition, “[t]he party to receive market differences must present [a] detailed settlement amount in writing to the other party within three business days. [And t]he party receiving bona fide settlement invoice must pay with good funds within five business days of receiving [sic] such invoice.” *Id.* In the ACSA-ATMI debates over the adoption of the three-quote rule, the shippers “felt it would be better to have an understanding [of the magnitude of damages] at the time [of breach], rather than after the fact, and thus avoid referring matters to the Board of Appeals.” Minutes of the ACSA-ATMI Joint Meeting (1976).

46. *See* SMRs, *supra* note 5, at Art. V, § 26 (requiring a penalty of one-half cent per pound in addition to interest when the buyer does not pay the draft or invoice within five business days after delivery); *id.* at Art. XVIII, § 55 (providing that if the seller fails to certify the origin or growth of the cotton, or certifies “growth other than that contracted for and such certification shows the cotton to be of irrigated growth, where raingrown cotton is specified or raingrown cotton where irrigated cotton is specified, the seller shall pay to the buyer a penalty of one cent per pound on that portion of the contract”).

47. *See* MCE TR, *supra* note 17, at R. 22, cl. 2.

48. *See id.* at R. 11, cl. 1 (“The penalty for failure on the part of the Seller to deliver cotton within the required time under above rules, shall be 10¢ per bale per day minimum to be paid by the Seller to Buyer and in no event shall this penalty exceed 25¢ per bale per day, but any excess over and above the 10¢ per bale per day is to be subject to the Buyer’s being able to furnish sufficient proof of loss for such excess.”).

payment.⁴⁹ Neither set of rules requires the aggrieved party to reveal any firm-specific information — such as profit margins, inventory stocks, or the identity of other customers or suppliers — in order to obtain a monetary recovery.⁵⁰

Another notable difference between the trade rules and the Code is the absence of a trade rule equivalent of the Code's nonwaivable duty of good faith. Although briefs often make arguments based on good faith,⁵¹ no such duty is implied by the arbitrators⁵² and notions of good faith and fairness do not appear to affect case outcomes. However, arbitrators sometimes do note in their opinions that they consider a particular outcome to be unjust,⁵³ or that one or both of the parties engaged in undesirable business practices.⁵⁴

49. *Id.* at R. 11, cl. 2 (“The penalty for failure on the part of the Buyer to pay for cotton or furnish shipping instructions in accordance with the above rules shall be 10¢ per bale per day plus storage, insurance and interest accumulated against the Seller during delay. Penalties accruing against the Buyer shall be added to the invoice, and those accruing against the Seller shall be deducted from the invoice.”).

50. In addition, the MCE's sensitivity to transactors' possible desire to keep information private is reflected in MCE TR, at R. 11, cl. 1, reprinted in part *supra* note 48 (providing for late penalties a buyer can get without revealing any firm-specific information, and larger penalties he is permitted to seek if he reveals additional information).

51. *See, e.g.*, Buyer's Brief at 23, BoA Case No. 135 (1992); Seller's Brief at 8, BoA Case No. 135 (1992) (where arguments relating to “good faith” and “bad faith” are made in the briefs but are not taken into account in the arbitration opinion); Buyer's Brief at 2, BoA Case No. 126 (1987) (“[T]here is an obligation of good faith implied in all contracts and in all commercial dealings between buyers and sellers.”); Buyer's Brief at 4, BoA Case No. 85 (1961) (“Seller has failed to live up to a contract, made in good faith and binding in every respect.”).

52. From 1944-1990, good faith was mentioned in only one MCE arbitration opinion. *See* MCE Case No. 816 (1966) (noting that the “[d]efendant acted in good faith and did everything he could to expedite the shipment;” the arbitrators ruled for the defendant but also noted that they were ruling as they did because the mill had agreed to take the cotton at a later time). Similarly, from 1978-1990, the BoA issued eighteen opinions, none of which mentioned “good faith.” It is possible, however, that in the few cases where compromise decisions were rendered on the grounds that both parties behaved badly, notions of good faith may have implicitly influenced arbitrator decision making.

53. BoA Case No. 122 (1987) (where BoA arbitrators considered the result they reached under the rules so unjust that their opinion contained a nonbinding “recommendation” that the Seller give the Buyer a type of offset that many other sellers in the market were giving to their buyers at that time); MCE Case No. 832 (1985) (“This Committee has abided to the best of its ability by the applicable rules of the Memphis Cotton Exchange. It is the feeling of this Committee, however, that a penalty is being imposed unjustly and even though we were committed to follow the rules, it is the very strong feeling of this Committee that, had both parties diligently [sic] and aggressively [sic] pursued the commitment [sic] of this contract, this Arbitration would not have been necessary. Unfortunately, this was not the case.”).

54. *See, e.g.*, BoA Case No. 137 (1996) (“This Board's opinion is that the contract was poorly handled by both parties under unusual circumstances and that their gross misunderstanding should be shared.”); BoA Case No. 130 (1990) (“We feel this transaction was poorly handled by both parties and that blame should be shared.”); MCE Case No. 837 (1991) (noting that “[P]laintiff did not exercise diligence [sic] in the maintenance of the contract in dispute”); MCE Case No. 822 (1971) (where the committee ruled: “(1) that the Committee take no part in a case involving a transaction which was, as admitted in writing in

3. *Adjudicative Approaches*

The most important difference between courts applying the Code and cotton industry arbitration tribunals applying the trade rules lies in their adjudicative approaches. Broadly speaking, the Code directs courts to look to immanent business norms reflected in course of dealing, course of performance, and usage of trade, to fill gaps and interpret contracts,⁵⁵ and directs them to take parties' actions under a contract as the best indication of what they intended their contract to mean.⁵⁶ In contrast, despite the fact that cotton arbitrators are chosen for their industry expertise, they use a relatively formalistic adjudicative approach that gives little explicit weight to elements of the contracting context.⁵⁷

Cotton trade rules do not contain provisions making course of performance or course of dealing relevant to gap filling or interpretation, and arbitrators are reluctant to take these considerations into account.⁵⁸ Similarly, unlike the Code, cotton trade rules do not have a general provision making usage relevant to the interpretation of either contract provisions or trade rules.⁵⁹ Unlike courts applying the Code,⁶⁰

the evidence submitted, in direct violation of the regulations governing such transactions; (2) that the parties involved would have been wise to settle their differences in this particular case as quickly and as quietly as possible"); MCE Case No. 809 (1960) ("This Committee would like to point out that the risk involved in a contract of this nature is very great for all concerned.").

55. This philosophy is reflected in numerous Code provisions and Official Comments. *See, e.g.*, U.C.C. § 1-102 (b) (1991) ("Underlying purposes and policies of this Act are . . . to permit the continued expansion of commercial practices through custom, usage and agreement of the parties . . ."); *id.* at § 1-103, § 2-314(2) (a), § 2-504(b), § 2-609(2), § 1-102 cmt. 1; § 1-205 cmt. 1; *id.* at § 2-202 cmt. 1(b) (explaining that language is to be given the "meaning which arises out of the commercial context in which it was used"); *id.* at § 2-202 cmt. 2.

56. *See id.* at § 2-208 cmt. 1 ("The parties themselves know best what they have meant by their words of agreement and their action under that agreement is the best indication of what that meaning was.").

57. Given the expertise of these arbitrators, however, these considerations may enter the moving papers and/or influence the arbitrators' decision-making processes in ways too subtle to detect.

58. When ten merchants who had served as MCE arbitrators were asked: "[I]f the parties could establish that despite what was written in their contract they always behaved in a different way, would you apply this different, informal understanding, rather than the relevant trade rule," two said yes, seven said no, and one was uncertain, explaining that it would depend on the identity of the parties. Briefs occasionally make arguments based on course of performance or course of dealing, but these considerations do not appear to influence arbitral decisions. *See, e.g.*, Record, BoA Case No. 122 (1987) (where both briefs contain numerous references to course of performance and course of dealing, but these considerations are not mentioned in the arbitrators' opinion).

59. However, the MCE Trade Rules contain one particularized reference to custom, *see* MCE TR, *supra* note 17, at R. 23, cl. 1 ("Rules 20, 21, and 22 are in no way to change or nullify the present rules and customs of handling sales of consigned or F.O.B. cotton when sold on actual samples."), and in quality arbitrations conducted by the CSAB, custom may be looked to when there are gaps not covered by the contract or relevant trade rules, *see* CSAB rules, *supra* note 5, at III, R. 8. ("All arbitrations will be held strictly in accordance with the

BoA arbitrators do not permit custom to trump or vary trade rules or explicit contractual provisions.⁶¹ In practice, BoA arbitrators only look to custom when there are no trade rules or contract provisions on point.⁶² On the whole, references to custom or usage in BoA opinions are extraordinarily rare,⁶³ perhaps because, given the amount of detail in the trade rules, cases involving contractual gaps are uncommon.

The MCE rules are silent on the applicability of custom. Some MCE arbitrators express a willingness to consider it, but in practice they do not seem to take it explicitly into account. Although custom is sometimes mentioned in parties' briefs, from 1944 to 1991, of the ninety-one opinions issued by the MCE, only three contain references to custom.⁶⁴

letter and intent of contract and in case all points of any contract are not covered by the rules . . . such points are to be arbitrated according to the general interpretation of the trade in regard to the same . . .").

60. See 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 *Merchant Law*] (discussing the ways that courts applying the Code permit custom to vary or trump explicit contractual provisions).

61. See, e.g., SEAB Case No. 77 (1956) (noting the buyer's contention that when "mills buy cotton from . . . Group B . . . according to precedent and established custom . . . it is understood to be compressed cotton," but rejecting it on the grounds that "while we recognize that precedent and established custom play a part in any transaction, the terms of the purchase [in this case] were definitely stated as subject to Southern Mill Rules and under Rule XVI, Section 53, DENSITY is covered . . . we therefore think Seller is right"); see also BoA Case No. 94 (1964) ("There were many contentions in very long briefs from both sides. However, this Board can only rule on the contract.").

62. In one case decided in 1935, the BoA looked to custom to define a term used but not fully defined in either the contract or the trade rules. See NEBoA Case No. 313 (1935) (holding that because the contract used but did not define the term "Western Growth," and the relevant trade rules did not define it either, "the Board must therefore base this decision on trade custom"); see also NEBoA Case No. 278 (1929) (noting that the terms of the contract were indefinite, and looking to the "correspondence submitted and the custom of the trade" in rendering its judgment). However, BoA opinions do occasionally refer to custom as an additional justification for a result reached on other grounds, or mention it in passing while attaching no particular significance to it.

A similar approach to the role of custom in adjudication is used at the WCSA. See, e.g., Telephone Interview with WCSA Executive (May 28, 1997) ("Whether [custom and usage] are viewed as relevant [in arbitration] depends on whether it relates to a subject about which there is a trade rule. If there is a trade rule on point, the custom is irrelevant. If there is not, then it might be looked to, to fill a gap, assuming that the contract too is silent on the point.").

63. For example, from 1929-1951, only four of the forty-two opinions issued by the BoA even mentioned custom or usage of trade. See NEBoA Case No. 313 (1935) *supra* note 62; NEBoA Case No. 308 (1931) (rejecting a buyer's claim that "the custom of the trade requires the Seller to ship bales not pounds" on the grounds that the New England Terms [a precursor to the SMRs] governed the trade and that Rule 27 of those terms "definitely states that cotton shall be delivered on a poundage basis."); NEBoA Case No. 280 (1929) Supplementary Decision (noting, in passing, that something was not a custom and withdrawing the original judgment pending submission of additional information); NEBoA Case No. 278 (1929), *supra* note 62.

64. See MCE Case No. 807 (1960) (holding that the plaintiff prevailed since it shipped on a route "usually used by shippers to this destination"); MCE Case No. 791 (1952) (re-

In general, cotton arbitrators decide cases in a highly formalistic manner,⁶⁵ even when their sense of fairness suggests that additional considerations are relevant or that a contrary result should be reached.⁶⁶ As one arbitrator explained, “[w]e look to the contract and then to the trade rules; this is all we have to base it [our decision] on. Other things like custom and the background [of the deal] are infinitely variable so we don’t look to them.”⁶⁷

4. Enforcement

The awards of both the BoA and the MCE’s arbitration tribunals can be enforced by seeking an entry of judgment in court.⁶⁸ However, this is rarely necessary. Failure to comply with a BoA award is grounds for expulsion from most shippers’ associations, and failure to abide by an MCE award is grounds for expulsion from the Exchange.⁶⁹

jecting a position based on custom and deciding the case on the basis of the SMRs); MCE Case No. 793 (1952) (“In ruling on the staple length the committee took into consideration the custom of the Trade in the territory involved . . . also four affidavits furnished by the plaintiff.”). In addition, custom is mentioned in one MCE Appeal, MCE Appeal of Case No. 787 (1952) (where, in affirming the decision below, which made no mention of custom, a custom is mentioned).

65. Formalistic adjudicative approaches are not uncommon in merchant-run private commercial law systems. *See, e.g.*, Bernstein, *Merchant Law*, *supra* note 60 (describing the formalistic adjudicative approach of the National Grain and Feed Association’s merchant arbitration system). *See generally* Lisa Bernstein, *Private Commercial Law*, in *THE NEW PALGRAVE ENCYCLOPEDIA OF ECONOMICS AND THE LAW* (Peter Newman ed., 1998) [hereinafter Bernstein, PALGRAVE].

66. *See, e.g.*, BoA Case No. 97 (1967) (revised) (“In most appeal cases, there are statements made by one side or the other, or both, that should in all fairness be taken into consideration in a friendly settlement. However, the Appeal Board must adhere strictly to the rules. To deviate therefrom would cause endless confusion and arguments. This Board can rule only upon the written contract.”); *see also supra* note 53 (discussing MCE Case No. 832).

67. Telephone Interview with Merchant #4, retired BoA arbitrator (Mar. 1997).

68. *See Outline of Services*, *supra* note 5, at 37 (“Should either party seek to have judgement entered upon the award pursuant to the 9 U.S.C. § 9, they may do so by applying to a court of competent jurisdiction located in Memphis, Tennessee.”); MCE TR, *supra* note 17, at R. 43, cl. 1 (noting that when the MCE enters an award “judgment upon the arbitrators’ award [in a proceeding under the new arbitration rule, *see supra* note 17] may be entered in any court having jurisdiction thereof”).

69. MCE BY-LAWS, *supra* note 10, at Art. IV, § 8. The MCE has also implemented another safeguard against the judgment-proof problem. In addition to paying the annual membership fee, members are required to purchase a membership in the Exchange. The By-Laws provide that when a member fails to pay an arbitration award, the prevailing party has a right to make a claim against his membership. If the noncomplying party still refuses to pay, his membership is auctioned off and the award is paid from the proceeds. At one time, these memberships were valued at about \$20,000, Telephone Interview with MCE Executive (Feb. 1997), although their value appears to have fluctuated widely, at least when sold at forced auctions. *See Keyer v. MCE*, 135 Tenn. 414, 420 (1916) (noting that an MCE membership sold for \$2,500); *MCE v. Pope*, 13 Tenn. App. 518 (1931) (noting that a MCE membership sold for \$4,500); *Capps v. Comm’r*, 14 T.C.M. (CCH) 505 (1955) (noting that a MCE membership sold for \$10,000). Today, however, the value of membership is approximately \$2,500,

Expulsions are widely publicized. Because membership in a shippers' association strongly affects the profitability of a merchant's domestic business⁷⁰ and is essential to participation in the international cotton trade, these association and exchange imposed penalties, together with their attendant social and reputational sanctions,⁷¹ are usually sufficient to induce merchants to promptly comply with arbitration decisions unless they are bankrupt or in severe financial distress.⁷²

Telephone Interview with MCE Executive (Feb. 1997), so this bond offers far less protection than it did in the past.

70. See *infra* notes 176-178 (discussing how a merchant's membership status in these associations affects mills' willingness to deal with him).

71. See *infra* notes 177-179 and accompanying text (providing evidence that transactors are very reluctant to deal with expelled members).

72. Moreover, even when the noncomplying party is in financial distress, the associations, most notably the shippers' associations, have succeeded in creating an implicit bankruptcy system that increases the likelihood that intra-industry debts, even those that are discharged in whole or in part in the public bankruptcy system, will nevertheless eventually be paid in full.

When a member of a cotton shippers' association becomes insolvent or files for bankruptcy, his membership in both his regional association and the ACSA is suspended. ATL. COTTON ASS'N BY-LAWS, Art. VI, § 2 (1995) [hereinafter ACA BY-LAWS]; S. COTTON ASS'N BY-LAWS, Art. 6, § 11 (1995) [hereinafter SCA BY-LAWS]; TEX. COTTON ASS'N BY-LAWS, Art. VI, § 10 (1993) [hereinafter TCA BY-LAWS]; W. COTTON SHIPPERS ASS'N BY-LAWS, Art. VI, § 6 (1994) [hereinafter WCSA BY-LAWS]; see also AM. COTTON SHIPPERS ASS'N BYLAWS, Art. 6, § 2 (1999), available at http://www.acsacotton.org/About_ACSA/Search%20Rules/about_acsa.html [hereinafter ACSA BY-LAWS]. Members of these associations are then notified of the action through association-promulgated circulars. See, e.g., ACSA Letter to Members (Oct. 19, 1995) (noting that [name of shipper] filed for reorganization "under Chapter 11 of the Federal Bankruptcy Act [and that t]he Southern Cotton Association has suspended the membership of . . . the above firm in accordance to their By-Laws pending further review and any action by their Board of Directors"). If, after going through the public bankruptcy process, a merchant wants to reenter the cotton business, he will, as a practical matter, have to gain readmission to an association. See *infra* notes 176-178 and accompanying text (discussing transactors' reluctance to deal with someone who has been suspended or expelled from a shippers' association). However, an affirmative vote of a large percentage of both the board of directors and the membership-at-large is required for readmission, and every member has the right both to object to a membership candidate and to publicize the reason for his objection at the association's expense. As a consequence, a former debtor who applies for readmission without arranging to repay his intra-association creditors in full is unlikely to be readmitted, even though the rules provide that readmission is formally contingent "upon establishing, through the presentation of sufficient proof, that all outstanding financial obligations have been fully satisfied or that the repayment schedule for all existing financial obligations is current." ACA BY-LAWS, *supra*. There have been instances where a former debtor was denied readmission for failure to comply with the repayment norm, subsequently paid his former creditors in full, and was then readmitted. Telephone Interview with SCA and ACA Executive (July 1996) (describing such incidents at the SCA and ACA); Telephone Interview with TCA Executive (no date) (describing such incidents at the TCA); Telephone Interview with Merchant #5 (no date) (explaining that being suspended or expelled has a large impact on a trader's ability to do business, and that to be readmitted to an association, you would have to pay 100% of your debt notwithstanding any legal discharge).

This implicit bankruptcy system may also partially mitigate the familiar incentive — which is especially acute in cash commodities markets — for firms to engage in overly risky activity when they are on the verge of insolvency. Because merchants who anticipate wanting to reenter the business after bankruptcy know that they will have to pay all of their intra-association (and perhaps intra-industry) creditors in full before being readmitted, they are

The ATMI does not expel mills that fail to comply with arbitration decisions, perhaps because ATMI membership is not a prerequisite for maintaining a profitable mill and such a sanction would have little force. However, in part because there are far fewer mills than merchants, when mills do not comply with arbitration awards, their non-compliance quickly becomes known throughout the merchant and banking communities, and the mill typically finds itself either unable to purchase cotton, or able to purchase it only at a relatively high price or for cash prior to delivery. As a result, noncompliance with arbitral decisions is uncommon unless the mill is in severe financial distress.

B. *Comparison of the Private and Public Legal Systems*

Some of the more important benefits created by the PLS stem from rather straightforward ways that its formal structures improve on aspects of the public legal system.⁷³

less likely to engage in certain types of overly risky behavior and end-period opportunism than they would be in the absence of the industry's well-organized associations. The industry's PLS, and the behavioral norms it encourages, make it possible to impose a sanction that exceeds the wealth of the party in financial distress (albeit by a finite amount, since a transactor can also become judgment proof with respect to reputational harm if he engages in enough wrongdoing that he is unlikely to be readmitted to a shippers' association even if he makes good his debts). The availability of these nonmonetary sanctions, like the punishment of incarceration rather than, or in addition to, a fine in the criminal context, in turn, mitigates the incentive of a transactor in financial distress to engage in end-period opportunism.

73. Some of the benefits of the private system could be partially captured through the public system, or through straightforward public legal system reform. Some of the benefits of the PLS's adjudicative procedures, for example, could be obtained if cotton contracts simply provided for American Arbitration Association ("AAA") administered arbitration. However, AAA-administered arbitration is often as costly and delay-prone as litigation. See Herbert M. Kritzer & Jill K. Anderson, *The Arbitration Alternative: A Comparative Analysis of Case Processing Time, Disposition Mode, and Cost in the American Arbitration Association and in the Courts*, 8 JUST. SYS. J. 6, 18 (1983) (concluding that "[o]ne does not save money by going to the AAA," rather than to state or federal court for claims above \$5,000). In addition, because the AAA's general arbitration rules give arbitrators wide-ranging discretion to grant continuances, see AM. ARBITRATION ASS'N, WHAT EVERY ADVOCATE NEEDS TO KNOW — A COMMENTARY ON THE COMMERCIAL ARBITRATION RULES OF THE AMERICAN ARBITRATION ASSOCIATION 20-21, 27 (1993) (discussing the granting of "postponements" and "extensions of time"), and because unlike cotton industry tribunals, the AAA cannot put any special pressures on parties to comply with its judgments, both pre- and post-award delay would likely remain a significant problem.

It is possible, however, that careful drafting of an arbitration clause and the adoption of special rules regarding the selection of industry-expert arbitrators and the avoidance of delay might reduce or eliminate these problems. At least one of the AAA's industry-specific tribunals has attempted these sorts of reforms. See, e.g., AM. ARBITRATION ASS'N, WIRELESS INDUSTRY ARBITRATION RULES (1997), available at http://www.adr.org/rules/commercial/wireless_rules.html (providing the option of "fast-track" arbitration with a "45-day 'time standard' for case completion" in front of a panel staffed by experts who are "engaged directly in the telecommunications industry").

Some of the benefits created by the trade rules could also be obtained if detailed, association-promulgated, standard-form contracts that contained rule-like provisions and that provided for general commercial arbitration were widely used by transactors in a particular market. However, if the arbitrators interpreting these contracts did so under the Code, which they would be likely to do since they are supposed to apply the law, many of the

The procedural rules reduce the cost and delay of obtaining and enforcing a judgment. They provide a streamlined process that, compared to the public system, makes it more likely that transactors will enter into new contracting relationships,⁷⁴ makes it easier for large and small firms to transact with each other,⁷⁵ makes smaller-sized transactions viable,⁷⁶ limits the ability of transactors to use the arbitral process to engage in strategic behavior,⁷⁷ and reduces the actual harm suffered

benefits of the rule-like provisions would be diminished. The Code's nonwaivable duties of good faith and reasonableness, *see* U.C.C. § 1-102 (1991) ("[T]he obligations of good faith, diligence, reasonableness and care . . . may not be disclaimed by agreement."), as well as its highly contextualized adjudicative approach, together with the AAA's direction to its arbitrators to achieve equitable results, may have the effect of transforming even rule-like contractual provisions into standards and transforming many of the transactors' extralegal understandings into enforceable contractual obligations. In addition, although reversal of arbitration decisions for failure to apply the law is quite rare, particularly when, as in AAA arbitrations, no opinion is written, an arbitral agreement making it clear that the law is not to be enforced would be problematic. *See* Stephen J. Ware, *Default Rules from Mandatory Rules: Privatizing Law Through Arbitration*, 83 MINN. L. REV. 703 (1999).

In contrast, in the industry tribunals, the arbitrators can simply pledge to uphold the trade rules, and because their reputations are on the line, they are likely to do so, particularly in industries like cotton where arbitrators sign their opinions. Moreover, a party who has lost an arbitration under the trade rules is unlikely to challenge the arbitrators' decision in court, unless an extraordinary sum is involved or he is planning to leave the industry. Bringing such a legal action would likely result in extraordinary reputational harm and perhaps de facto ouster from the industry. As a consequence, even a general commercial arbitration tribunal charged with interpreting detailed standard-form contracts under expedited procedural rules could not provide all of the benefits of a PLS.

74. By reducing the cost of dispute resolution and increasing the likelihood that arbitral awards will be paid, the procedural rules, together with the shipper association membership rules, *see infra* note 167 and accompanying text, may make transactors more willing to initiate new trading relationships since they will be better protected in the event of nonperformance.

75. For example, if a small merchant were forced to contract with a large mill under the public legal system, the small merchant might decline to file even a meritorious claim, knowing that legal costs are generally high and that the mill's in-house legal staff would be able to use many delaying tactics that, combined with the delay inherent in the judicial process, might put him out of business. As a consequence, large firms would, in effect, be unable to make legally enforceable promises to small firms.

76. By reducing the cost of dispute resolution, the PLS transforms some meritorious claims that would have had a negative expected value in the public system, and therefore would most likely not have been filed, into positive expected value claims. As a consequence, the system makes it possible to enter into smaller contracts that are more likely to be performed, since each party has a credible threat to go to arbitration if they are not. The ability to enter into smaller-sized transactions not only helps small firms compete with larger ones, but is also beneficial to mills. When a mill is able to purchase smaller amounts from multiple suppliers, it is better able to diversify away the risk of inadvertent breach, a risk that remains significant even when merchants take the optimal amount of care. *See infra* text accompanying notes 216-219.

77. For example, because cotton tribunals do not permit unrestrained party-initiated discovery, transactors have no incentive to bring the type of nonmeritorious suit that if brought in the public legal system might nonetheless result in a settlement since the defendant would have an incentive to settle for any amount below the discovery costs that the plaintiff could credibly threaten to impose on him before incurring significant costs herself. *See* David Rosenberg & Steven Shavell, *A Model in Which Suits Are Brought for Their Nuisance Value*, 5 INT'L REV. L. & ECON. 3 (1985). Moreover, because these tribunals endeavor

by transactors who do not have access to capital on reasonable terms during the pendency of a dispute.⁷⁸ In addition, by providing for the appointment of industry-expert arbitrators, who can make many factual determinations more accurately and less expensively than a judge or jury can, the rules greatly expand the “contractible” aspects of an exchange. The use of stream-lined procedures together with the appointment of expert adjudicators transforms considerations that in the public legal system would have been only observable to the parties — that is, knowable by the parties but not worthwhile for them (from an *ex ante* perspective) to prove to a tribunal in the event of a dispute — into considerations that are also verifiable — that is, worthwhile to prove to a tribunal in the event of a dispute⁷⁹ — thereby encouraging transactors to enter into more complete contracts.⁸⁰

The substantive rules provided by the PLS also facilitate contracting in ways the Code does not. They reduce the cost of entering into an agreement by providing a comprehensive set of well-tailored default rules that reduce the negotiation costs, specification costs, information costs,⁸¹ and relational costs⁸² of contracting, as well as the risk

to keep the existence of a dispute secret, at least until a judgment is rendered, the arbitral process discourages the filing of suits solely for the settlement value that is created by their cloud on title effect, that is, for the harm that the mere existence of a lawsuit causes to someone's reputation during the pendency of the dispute. See Edward Bernstein, *Law & Economics and the Structure of Value Adding Contracts: A Contract Lawyer's View of the Law & Economics Literature*, 74 U. OR. L. REV. 189 (1995) (discussing the cloud on title theory of the nuisance suit). Even though the existence of a dispute sometimes leaks out through gossip, because disputes are resolved faster, the monetary effect of the cloud will be much smaller. In addition, industry arbitrators' reluctance to grant continuances or postponements of hearings and decisions, limits the ability of a party to use the threat of delay to persuade his adversary to accept a lower settlement.

78. See Telephone Interview with MCE Executive (Feb. 1997) (“When a little guy [merchant] isn't paid, he may suffer huge financial harm.”).

79. Alan Schwartz, *Relational Contracts and the Courts*, 21 J. LEGAL STUD. 271 (1992) (defining and discussing the distinction between observable and verifiable information).

80. Encouraging more complete contracts reduces the number of unprovided-for contingencies, and may therefore reduce the number of disputes.

81. Information costs are the costs to a transactor of understanding the terms of a particular transaction. When deals are concluded against the background of detailed standardized defaults, and variations are prominently noted in the special remarks section of a confirmation, transactors bear the costs of learning the meaning of the defaults only once and in an individual transaction need only take note of the modified terms. When transactors understand the terms of their contracts, they are less likely to seek legal advice before entering into deals, thus reducing legal costs.

82. Relational costs are costs that arise from the fact that, in many contexts, transactors approach the task of reaching an agreement “with an idea of how similar transactions are usually structured; they have in their minds an implicit form contract made up of clauses such as price that are commonly negotiated, boilerplate provisions, and legal default rules [and extralegal provisions]. A party may be wary of suggesting too many deviations from the implicit form contract since these might be interpreted as a signal that he is a less reliable or more contentious trading partner than the average market participant. . . . [T]his signal might, in turn, lead the other party to either propose additional provisions or demand a price adjustment to compensate him for the added perceived risk that a dispute will arise. It might

of transaction breakdown. The clarity of the rules, together with the efforts associations make to ensure that transactors understand them,⁸³ reduces the likelihood that misunderstandings will arise and helps to promote settlement when disputes do arise by making arbitral outcomes relatively predictable. In addition, as compared to individually drafted and negotiated contracts, where free rider problems and network externalities often lead to the undersupply of innovative provisions and the lock-in of inefficient contractual provisions,⁸⁴ the availability of industry trade rules facilitates the creation and introduction of new contract governance provisions.⁸⁵ The industry's private legislative process overcomes the free rider problem by collectivizing the costs and benefits of the new provisions and reduces the network bias

also increase the risk of transaction breakdown as well as the likelihood that the transaction will not be consummated by the relevant deadline." Lisa Bernstein, *Social Norms and Default Rules Analysis*, 3 S. CAL. INTERDISC. L.J. 59, 71-72 (1993). Avoiding relational costs is particularly important in merchant-to-mill transactions where the value of the transaction as a whole is strongly affected by the ability of the transactors to cooperate during its execution.

83. See *infra* notes 192-196 and accompanying text (describing the ways the associations try to educate member transactors about the content of the rules).

84. See Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261 (1985).

85. Another advantage of industry-provided trade rules over individually drafted contracts is that they may enable transactors in the market as a whole to overcome coordination problems. Evolutionary game theory models suggest that, in an environment where two coordination achieving norms are initially available, coordination will be achieved over time even when each market transactor independently decides which norm to follow. However, there is nothing in these models to suggest that these individual choices will necessarily lead to the adoption of the more efficient norm. Which norm will ultimately win out depends, among other things, on the initial distribution of norm-following strategies selected by members of the relevant group at the time the game begins. In such situations, if the less efficient norm wins out, it is likely to retain its dominance since the norm will constitute a Nash equilibrium. See Jack Hirshleifer, *Evolutionary Models in Economics and Law: Cooperation Versus Conflict Strategies*, 4 RES. L. & ECON. 1, 13 (1982). In the cotton industry, where coordination of terms and behavior is important, the centralized provision of trade rules increases the pace at which norm convergence is achieved, and when transactors wind up locked into an inefficient norm, trade rule changes can provide the exogenous shock that moves transactors to the more efficient equilibrium. An examination of trade rule amendments in numerous industries that have PLSs demonstrates that adapting to technological innovations and other changes that require a coordinated response from market participants is a very common reason for trade rule amendments.

One of the interesting features of these evolutionary equilibria is that the proportion of the initial population adopting a particular norm does not have to be notably large for the norm to become an evolutionary Nash equilibrium. This suggests that in a market where large firms such as cotton mills have a preference for a particular norm and choose to follow it, they may constitute a high enough proportion of the initial population of traders to ensure that the norm is adopted market-wide. This may be a reason that an industry as a whole may be better off if its rules are made through a legislative process in which each firm, regardless of its size, has one vote, thereby more nearly equalizing the effect of firm size on the rules creation process.

against new terms by ensuring that the new provisions will be incorporated into most industry contracts in the future.⁸⁶

The adjudicative approach used by the industry tribunals also benefits transactors. It encourages settlement by making arbitral outcomes easier to predict and promotes flexibility in the course of contracting relationships by refusing to transform extralegal understandings or patterns of adjustments into legally enforceable obligations. This adds significant value to contracting relationships. Cotton transactors consider one another's willingness to make such adjustments important. There are often stages in a contracting relationship at which adjustments that create tremendous benefits to one party while imposing minimal costs on the other can, in fact, be made; yet transactors would be far less willing to make these adjustments if there was even a small risk that they might be required to do so in the future, a risk that is very real in the public legal system due to the Code's course of dealing and course of performance provisions.⁸⁷ For exam-

86. This benefit is more substantial in the exchanges and shippers' associations, in which (at least at the time the initial sets of rules were adopted) most transactors were buyers one day and sellers the next, than it is with respect to the SMRs, which govern merchant-to-mill disputes. A review of the minutes of the joint ACSA-ATMI annual meetings devoted to SMR revisions, from 1947 to 1990, suggests that changing the SMRs is a long and arduous process rife with interest group politics. Nevertheless, over that same time period, sixty-six amendments to the rules (some important, others not) were passed.

The availability of well-tailored trade rules may, however, have the undesirable effect of reducing the rate of contract innovation through individually drafted contractual provisions. The cost of drafting new provisions will be nearly the same as it would have been were the contract to have been governed by the legal system, while the marginal benefit of including an innovative term may be smaller since the trade rules are already well suited to the transactions they govern. This effect may be reinforced if the terms supplied by the trade rules become part of an embedded reference transaction that transactors become increasingly unwilling to depart from. On the other hand, industry tribunals' willingness to give effect to contractual language increases the incentive to draft and include innovative provisions.

87. As both mills and merchants have grown into larger, more complex entities, this feature of the system has become increasingly important. In many contracting relationships, the people who enter into the agreements are not the same people that perform them (such as shipping clerks, truckers, and loading dock managers). In such situations, it makes sense for companies to give their employees the authority to make one-time adjustments where it seems desirable to do so. For example, if a truck arrives an hour after closing one Friday, and the loading dock manager happens to be around finishing some paper work, it would be desirable for him to agree to permit unloading of the truck — it does not cost him much and it saves the merchant the cost of paying the trucker to stay with the load over the weekend. If, however, the loading dock manager thought that by agreeing to unload in this particular instance, he would be giving the trucker the right to require him or another loading dock employee to keep the loading dock open late on another Friday, he might not agree to unload the truck. Although under the Code, one act does not constitute a course of performance, one loading dock employee might not know if another employee had agreed to a similar adjustment the previous Friday, or if another employee would agree to a similar adjustment the next Friday, thereby enabling the trucker to claim that failure to accept a late delivery on a Friday was a breach of contract by the mill (assuming the mill did not issue a written notice that no late deliveries would be accepted again and that strict compliance was required). Alternatively, the loading dock manager could simply be instructed by the company to have the trucker sign a waiver as a condition of unloading. However, such an approach might undermine the "good old boy" aspect of the relationship, which plays an important role in reducing the types of frictions that increase the cost of performance. In

ple, in merchant-to-mill transactions, the inventory costs to a merchant of giving a mill an absolute right to demand early or postponed delivery would be prohibitively high, yet there are many instances when, if a mill asks for early or postponed delivery, the cost of accommodating the request turns out to be low. Indeed, although cotton industry trade rules and contracts provide clearly specified delivery times, it is understood that when making an adjustment is not too costly to the merchant, the adjustment will be made. As one merchant explained, it is important to have a reputation for being flexible since "adjustments are a common part of doing business. If someone is short of warehouse space, you agree to delay delivery; if someone needs a shipment early, you are ready to go, so you do it."⁸⁸ Conversely, on the mill side, "a mill's reputation for being flexible [when the merchant wishes to deliver early or late] is factored directly into the price; a much higher price is charged to those who are not flexible."⁸⁹

Finally, the private system has a number of features that are designed to reduce the most serious problem facing PLSs generally, namely, the risk of arbitral bias.⁹⁰

addition, a system of written waivers would impose administrative costs on the firm. If these intra-firm transaction costs were high enough, firms might simply instruct their agents not to make these types of accommodations, thereby introducing considerable rigidity into contracting relationships as compared to the situation created by the PLS where these adjustments can be made by agents on the ground without creating costly risks for their principals. For a more complete discussion of the inflexibility costs introduced by the Code's course of dealing and course of performance provisions, see generally Bernstein, *Merchant Law*, *supra* note 60.

88. Telephone Interview with Mill Representative #1 (Apr. 2, 1997).

89. Telephone Interview with Merchant #12 (June 1997).

90. The PLSs' adoption of bright-line trade rules that leave less discretion to the adjudicator than the Code does may help to reduce arbitral bias by making it easier to catch and therefore less likely to occur. The effectiveness of bright-line rules in constraining bias depends, in part, on the type of bias to be resisted. If, for example, the arbitrators themselves are assumed to be neutral actors who are subject to pressure by industry interest groups, being able to justify their decisions on the grounds that the result was "required" by a clear rule (and thus not a matter of individual choice) may help them withstand this type of pressure. A desire to reduce the incentives of various groups to apply this type of pressure may be one of the reasons that arbitral opinions are not accorded precedential value, and that rule-making authority is clearly allocated to the associations' private legislatures. If, however, the arbitrators themselves are assumed to have a preference for rendering biased judgments, rule-like provisions will impose only weak constraints. Fact-finding can often be manipulated to make outcomes appear dictated by the rules themselves. As a consequence, a desire to demonstrate the impartiality of the tribunal may be a partial explanation for the BoA's old practice of circulating the evidence and arguments submitted to arbitrators together with its written opinion. *See supra* note 28.

Another feature of the system, the fact that BoA arbitrators are not permitted to know the names of the parties, is also a way of reducing the likelihood of bias against a particular individual. It is not, however, particularly helpful in reducing another type of bias that might arise in this tribunal, namely, industry-segment bias — since the Board does know which party is the merchant and which is the mill. Nevertheless, the circulation of BoA's opinions may discourage the Board from systematically favoring one segment over another, since this would become apparent to industry participants, who might then opt not to include BoA arbitration provisions, or the SMRs, in their contracts.

C. Conclusion

Despite the fact that the cotton industry's PLS is so well run and so well tailored to the needs of the industry, cotton transactors do not rely exclusively, or even primarily, on the easy access to monetary remedies it provides to create the desired incentives for contractual performance. Rather, individual transactors attach great weight to the reputations of their transacting partners, and the institutions that create and administer the PLS also engage in many activities that are designed to strengthen the social basis of trade and to promote the flow of reputation-related information through the industry. These efforts succeed in making reputation-based nonlegal sanctions (like negative gossip, which may lead to refusal to deal) an important force in the industry. They work in tandem with the monetary sanctions available in arbitration to provide desirable breach-or-perform incentives and to enable transactors to devise better contract governance structures than they could in their absence. As a consequence, in order to fully understand the ways that cotton industry institutions influence cotton transactions, it is useful to look at the importance of reputation at different stages of a typical transaction as well as the myriad of ways that cotton institutions seek to strengthen both the social and informational infrastructures of trade.

II. REPUTATION AND REPUTATION-BASED NONLEGAL SANCTIONS

A. *The Creation and Importance of Reputation-Based Nonlegal Sanctions*

The importance of commercial reputation in the cotton industry is due, in large part, to the type of commodity cotton is, as well as to the ways that standard trades are structured and financed. Unlike many commodities that can be graded objectively, cotton grading has traditionally been a subjective process.⁹¹ There are numerous grades and

At the MCE, the norm of consensus in arbitral decision making (from 1944-1991, only four of the ninety-two cases decided were not unanimous) and the use of seven-arbitrator panels may also be ways of attempting to constrain arbitral bias.

91. See, e.g., FRANK A. RICHARDS, *THE MARKETING OF COTTON AND THE FINANCING OF COTTON MERCHANTS* 3 (1949) ("The classification [of cotton] is . . . an art, not a science."); JOHN A. TODD, *THE MARKETING OF COTTON: FROM THE GROWER TO THE SPINNER* 102 (1934) ("The value of cotton is judged by its grade, length and strength of staple, and character . . . Grade is largely a question of appearance, and judgment is a matter of a good eye . . . [b]ut it is in judging the staple that expert knowledge is particularly necessary . . . There is no absolute opinion on staple, however, experts often differing over the same sample; indeed, the same bale will often appear to vary every time it is sampled."). In 1981, however, a more objective grading technique known as High Volume Instrument (HVI) Classing was introduced. The cost of HVI classing has limited its use in small and medium-sized private transactions, but it is widely used in grading cotton subject to govern-

over forty other features that go into the description of a single lot of cotton.⁹² The nonhomogeneity of cotton, and the difficulty of describing a particular bale with precision, is one reason that cotton is often sold “on sample.”⁹³ It is also a reason that the commercial reputation of the seller is so important to the buyer, particularly when the sale is concluded over the phone without physical inspection of the goods. As one merchant put it: “You want to do business where you know people and can depend on what they say about quality, since it is so subtle and so subjective. You are more likely to rely on quality when you know the guy.”⁹⁴ The short-term volatility of cotton prices, the high-volume, low profit margin nature of a typical merchant’s operations, and the fact that many agreements are not confirmed in writing until days after they are made, make all transactors concerned about the reputations of the people they deal with. As one market participant explained: “[R]eputation is essential in this business. Millions of dollars of business will be done on the basis of a thirty-second phone call. Agreements are essentially oral; they are documented for tax, invoice, or customs reasons.”⁹⁵ And, as another noted, “[r]eputation matters because you conclude sales one day, and the confirmations do not follow for as much as a week or ten days, so during that time period, the integrity of a person’s word is the only thing that bonds the contract.”⁹⁶

ment-sponsored programs. COTTON COUNCIL INT’L 1996 COTTON USA BUYERS GUIDE 13 (1996).

92. See COTTON COUNCIL INT’L 1996 COTTON USA BUYERS GUIDE § 6 (1996) (describing the sixty-nine varieties of American Upland Cotton, together with their staple lengths, micronaire ranges, and fiber lengths, as well as “25 color grades and five categories of below grade color” and “seven leaf grades . . . [and] one below leaf grade category”).

93. A sale “‘on sample’ means the sale of particular bales by the samples drawn from them; that is, the purchaser receives the specific bales represented by the samples he selects.” TODD, *supra* note 91, at 95. Other methods of designating quality include: a sale “on type” which “is practically equivalent to sale on private brands. The type samples are not offered as representing specific bales, but as the type of cotton the merchant can deliver,” and sale “on description,” which “means the sale of cotton with a certain designated grade and staple, without the presentation of samples.” *Id.*

94. Telephone Interview with Merchant #8 (July 1996).

95. Telephone Interview with Merchant #4, retired BoA arbitrator (Mar. 1997). Oral contracts are enforceable irrespective of their size. See SMRs, *supra* note 5, at Art. I, § 2 (noting that a contract may be formed orally but “all contracts for the sale of cotton must be confirmed promptly in writing by both parties to the contract”); MCE TR, *supra* note 17, at R.1, cl. 1, 3 (“A contract for the sale of cotton shall be deemed final when the price, quantity, quality, time and place, or places, of delivery and terms of sale have been agreed upon between the Buyer and Seller and no contract can be rescinded without the mutual consent of both parties thereto” but “[w]ritten confirmations of all sales shall be presented or mailed by Sellers to member Buyers within twenty-four hours after the sale is made.”). However, it is difficult to establish the existence of an oral contract since arbitrators are reluctant to rule on the basis of conflicting oral testimony alone.

96. Telephone Interview with Merchant #5 (no date); see also Telephone Interview with Merchant #6 (no date) (noting that the cotton industry is “a community of people who are in the business of trading with one another, which requires that more integrity must exist. . .

Commercial reputation is particularly important in merchant-to-mill transactions. When a mill needs a particular type of cotton to keep its looms running, and this type of cotton may not be readily available on the spot market, the mill must rely on the merchant's reputation for timely delivery of the precise type of goods promised.⁹⁷ Similarly, mills can take many actions that strongly affect the value of the transaction to the merchant but are not strictly prohibited by either the governing trade rules or most merchant-to-mill contracts, such as refusing to accept delivery outside of narrowly defined times, thereby forcing merchants to incur the cost of holding cotton in trucks over nights and weekends.⁹⁸

The way cotton transactions are financed also contributes to the importance attached to commercial reputation. Most merchants operate on a slim cash flow margin.⁹⁹ Typically, more than eighty-five percent of the operations of all but the largest merchants are financed by one of three banks. This type of merchant banking is very personal. Banks inquire directly into the commercial reputations of their borrowers, and a merchant's reputation, along with the reputations of the mills he sells to, strongly affects the interest rate he will have to pay.¹⁰⁰ As one merchant noted, "[b]anking institutions have veto power over who merchants do business with."¹⁰¹ And, as a prominent industry banker explained, "[w]hen approached by a merchant for credit, a bank lending officer's first task is to become intimately acquainted

[you] don't need explicit contract[s] or confirmation to backup what you said. What you say is key to the buyer . . . face to face, telephone conversation, fax machines, long distance, by voice; you have to be able to know the person you are dealing with [and] in markets of our size this is possible"); *Cotton Merchants and Cowboys — Diamonds and Denim*, THE COTTON DIGEST INT'L, Vol. 74, No. 1 (1999) 10, 12 ("The Cowboy and the Cotton Merchant are also honest and loyal. . . . [With the cowboy, a]ll you had in life was your word, your handshake, and the image you portrayed. The cotton merchant today lives by these same rules, his word is his bond in trading, and if he does not perform on his obligations, he quickly finds himself where no one will trade with him (or ride with him as we say out West)).

97. Telephone Interview by Connie Rogers with MCE Merchant #8 (Aug. 13, 1997) ("[P]erformance on fulfilling contracts is what determines reputation — basically quality, on-time delivery.").

98. For more examples of these costs, see *infra* notes 135-136 and accompanying text.

99. Moreover, mills typically pay merchants ten days to two weeks after delivery, leaving merchants to finance this cash gap, which in turn makes a mill's reputation for prompt payment very important to the merchant.

100. See, e.g., FRANKLIN W. RYAN, THE COTTON MILL SALE-NOTE: AN ANALYSIS FROM THE VIEWPOINT OF BANK CREDIT ADMINISTRATION, 5 (1921) (explaining that when a bank lends to a merchant there is "an indirect credit extension to the cotton mill. The bank lends to the merchant to enable him to sell cotton to the mill on credit. The bank looks to the merchant primarily for the final payment of the loan but the biggest element in the loan is the moral risk and the mill management is an important factor in the moral risk when the cotton is stored in the mill's own warehouse as is the usual procedure").

101. Telephone Interview with MCE Merchant #10 (no date).

with the merchant's character, background, experience, and conservatism."¹⁰²

Given these considerations, it is not surprising that cotton transactors view commercial reputation as an essential business asset whose value will often be reflected in the selection of transactional partners¹⁰³ as well as in the transaction price,¹⁰⁴ the transaction structure, and other terms.¹⁰⁵

The most important determinants of a cotton transactor's reputation are his record for prompt payment of his debts, his willingness to meet his contractual commitments (that is, not to "lay down" on a contract),¹⁰⁶ his willingness to be flexible in work-a-day interactions,¹⁰⁷

102. See *Cotton Financing*, typewritten pages with the card of C.W. Butler III, First Vice-President, National Bank of Commerce Memphis, stapled to it; see also RICHARDS, *supra* note 91, at 37-38 ("As the cotton business is highly specialized, the merchant's experience and competence are important factors to be considered," and "[m]any bankers make a regular practice of extending more liberal credit to established, reputable merchants than they ordinarily extend to borrowers in other types of business ventures.").

103. Telephone Interview with TCA Executive (no date) ("In this business, you just won't deal with folks you don't know; you need a really large price differential to take a chance.").

104. Telephone Interview with Merchant #1 (no date) ("Mills get a reputation about how flexible they are when certain circumstances arise [and] a merchant considers this very valuable business knowledge, this information about how flexible a mill will be. Some mills are more stringent about adjustments, and are very strict about demanding exact conformity to the contract. These mills have to pay more for cotton than mills who are willing to be more flexible. The market knows."); Telephone Interview with Merchant #7 (June 1997) ("Reputation is figured discreetly into the price someone has to pay for goods."); Telephone Interview with Merchant #8 (July 1996) ("One's reputation is an integral part of the price another is willing to pay for his goods . . . If a merchant has a bad reputation, there are mills who won't deal with him, and other mills who might deal with him, but only at a discounted price.").

105. Telephone Interview with Mill Representative #1 (Apr. 2, 1997) (explaining that mills who refused to work with merchants after severe weather affected the micronaire of a crop that had been sold for forward delivery "found that now merchants do not want to enter into long-term contracts with the[se] mills although they are still willing to enter into shorter-term contracts with them"); Telephone Interview with Merchant #9 (July 1996) (noting that the influence of reputation on the selection of contracting partners depends on the length of the contract).

106. See, e.g., Telephone Interview by Connie Rogers with MCE Merchant #1 (July 17, 1997) (citing "laying down on a contract, bankruptcy, [and] not paying a debt," as actions that would lead him not to deal with someone); Telephone Interview by Connie Rogers with MCE Merchant #2 (July 18, 1997) (explaining that you get a bad reputation when you "book a head and can't pay for it," or when you "lay down on a contract"); Telephone Interview by Connie Rogers with MCE Merchant #4 (Aug. 8, 1997) (explaining that "past history determines reputation," adding that he wouldn't deal with someone who would "lay down on the contract"); Email from merchant participant to author, to Cotton-L Listserv (Sep. 29, 1997, 2:33:26 PM) ("A cotton merchant or buyer who has a good reputation is one that honors his word, whether it be in writing or is oral. He does what he said he'd do. If something goes to arbitration in a dispute, he agrees to go along with the decision. He expects to be treated fairly. A bad reputation comes from not honoring one's word, lying, or failing to fulfill [sic] on a commitment [sic]. This can be done by either of the parties involved. An example is changing the class on cotton traded to reflect a quality difference. Another is selling one type of cotton, and knowingly delivering another quality that has a different value.").

and his willingness to renegotiate commitments when circumstances change or adverse events occur.¹⁰⁸ Other important attributes include a merchant's record of on-time delivery of the precise quality of goods specified¹⁰⁹ and a mill's reputation for promptly accepting delivery. The rules of most cotton associations as well as the rules governing merchant-to-mill transactions implicitly recognize the importance of each transactor's reputation by making cotton contracts non-assignable.¹¹⁰

The importance of reputation and the industry's reliance on reputation-based nonlegal sanctions ("NLSs") goes back to the early days of the industry when NLSs were a rather inexpensive way to support exchange.¹¹¹ Deeply rooted social forces, such as the culture of honor in the Old South and the close-knit nature of many small town mill communities,¹¹² helped to ensure that a transactor's sense of self-esteem, his position in the community, and his social connections were intertwined with his business reputation, making breach of contract something that would hurt not only his business prospects but also his standing in his social community.¹¹³ As one transactor explained, "the head of a mill used to be a senior citizen in the community. His self-esteem depended on how he did business."¹¹⁴ And, as another noted, "[u]ntil quite recently, most of them [MCE members] had their offices

107. Telephone Interview with Merchant #1 (no date) ("Reputation is key. I care about how long someone has been in the business, and I care about whether, if there is a problem, they come to me immediately and try to work it out."); Telephone Interview with Merchant #12 (June 1997) ("A mill's reputation for being flexible is factored directly into the price; a much higher price is charged to those who are not flexible."); *see also supra* text accompanying notes 87-89.

108. *See, e.g.*, Telephone Interview with Mill Representative #2, former BoA arbitrator (no date) ("When I deal with an honest man, I know whatever happens we can work it out. If a guy has a tarnished reputation, I can't count on this and will not deal with him!").

109. *See, e.g.*, Telephone Interview by Connie Rogers with MCE Merchant #8 (Aug. 13, 1997) *supra* note 97.

110. *See, e.g.*, SMRs, *supra* note 5, at Art. IV, § 21 ("All contracts for the sale of cotton must be filled and received by the parties making the contracts."); MCE TR, *supra* note 17, at R. 9, cl. 1 ("No order for the delivery of cotton is transferable without the knowledge and consent of Seller.").

111. Another consideration that might have motivated the industry to actively promote the availability of NLSs in the early days of the PLS is that prior to 1920, arbitration awards were not legally enforceable, so the reputational harm of being known as a welcher and being expelled from an association was the only force that the associations could harness to induce transactors to comply with arbitral awards.

112. *See generally* JACQUELYN DOWD HALL ET AL., *LIKE A FAMILY: THE MAKING OF A SOUTHERN COTTON MILL WORLD* (1987).

113. *See generally* GEORGE S. BUSH, *AN AMERICAN HARVEST: THE STORY OF WEIL BROTHERS-COTTON* 421-39 (1982) (exploring this theme in the chapter *Now I Lay Me Down to Cheat*).

114. Telephone Interview with Merchant #9 (July 1996).

on Front Street in Memphis; they saw one another each day and viewed themselves as being part of the same club.”¹¹⁵

Although these background social and communal forces have gradually become weaker,¹¹⁶ over time, cotton industry institutions have sponsored a variety of activities designed to recreate and maintain the types of deeply interconnected business and personal relationships that made social trust-based reputation enforcement mechanisms effective. Over the years, the MCE has sponsored the local debutante ball, an annual civic cotton carnival that came to be viewed as the Mardi Gras of Memphis,¹¹⁷ golf tournaments, a Cotton Wives Club with its own publication, “Cotton Tales,”¹¹⁸ a well-known domino tournament, and numerous other civic events.¹¹⁹ And, to this day, re-

115. Telephone Interview with MCE Executive (Feb. 1997).

116. Despite the weakening of these social and communal forces, industry publications continue to romanticize the values of the south. See, e.g., Mac Isaacs, Editorial, *Despite It All, People Are Still the Industry's Most Important Asset*, TEXTILE WORLD, May 1999, at 9 (observing that the “senseless acts of violence [in Littleton, Colorado] turns [sic] one’s thoughts to yesteryear in the annals of this great textile industry. Time was, in those days of family owned and operated companies and mill villages, the company not only provided employment, but offered safe havens that met the needs of most families as well . . . Above all, [there was] a genuine care and concern”).

117. See, e.g., EVERETT R. COOK, MEMPHIS: COTTON’S MARKET PLACE 11, 12 (1942) (describing the 1931 origins of the MCE sponsored cotton carnival, which by 1942 had grown to “include an Indian fight with De Soto on the levee, a parade taking for its theme ‘Way Down South’, a pet parade, a marathon race . . . [and a] horse drawn carriage . . . holding the King and Queen . . . [that] ranks now only next to the New Orleans Mardi Gras in its spectacular exhibition and attendance”).

During Carnival’s heyday, “[t]he arrival of the royal couple at the river front” would be “followed by a series of parades . . . interspersed by beauty pageants, sporting competitions, luncheons, fashions [sic] shows, and public and private dances.” Robert McLean, *Cotton Carnival and Cotton Makers Jubilee: Memphis Society in Black and White* 8 (1994) (unpublished thesis, George Mason University). All of this glittering activity was sustained by “[t]he business and social elite from the tri-state area,” many of them cotton men, of course. These, “joined by local residents, fellow members in one of Carnival’s ‘secret societies,’ . . . sponsor[ed] many of Carnival’s events, especially those not open to the public.” *Id.* at 3. Over time, however, the Cotton Carnival began a decline, suffering from “charges of class and racial elitism.” *Id.* at 170. For the next three decades after the death of Martin Luther King Jr. in Memphis, the process of dissolution continued. “The concept of mock royalty by those who in many ways, were in charge of the ‘kingdom,’ became ludicrous. Carnival ceased to entertain and instead became the embodiment of the divisions — social, economic, and racial — that prevented the city from developing.” *Id.* at 148. Today, the Carnival is scarcely a visible presence.

118. By 1979, over eighty cotton wives clubs existed nationwide. Letter from the Club President, to Friends of Memphis Cotton Wives (Oct. 17, 1980).

119. Forrest Orren Lax, *The Memphis Cotton Exchange From Beginning to Decline* 128 (1970) (unpublished thesis, Memphis State University) (“Because the Memphis Cotton Exchange was composed of the most influential men in Memphis it was easily the most important institution in the city. For many years the Exchange was not only an organization of cotton men but also civic minded men who used the Exchange to help the city. City problems were discussed in many Exchange meetings with little mention of cotton. At times one gets the impression that the Memphis Cotton Exchange ‘was’ the city of Memphis . . . It was probably the first organization in Memphis to actively participate in charity drives for the poor of the city. It certainly was a leader in combating disease in Memphis. Many victims of floods also had reason to hold the Exchange in high esteem.”).

gional shippers' associations continue to encourage social interaction among their members and their families by making their annual conventions family events, complete with special entertainment for children and "the ladies."¹²⁰ The interweaving of business and social identities is further encouraged by the light-hearted social tidbits that can still be found in industry-sponsored publications.¹²¹ The close connection between transactors' business and social relationships is aptly summed up by one merchant who explained that:

Merchants take mill buyers on hunting trips just like in any other business . . . In the process, relationships . . . develop[.]. Over time, a buyer gets the idea that he wants to deal with me not just because of our business relationship, but also because of our personal relationship. So you tell me, when you want to do business, who will you call, the guy you like, or the guy you don't like?¹²²

Cotton industry institutions' efforts to maintain and strengthen social trust-based group solidarity and to facilitate the informal flow of reputation information were greatly aided by the organization of shippers' groups into close-knit regional associations and exchanges with their own well-developed social groups¹²³ and gossip networks.¹²⁴

120. See, e.g., *Convention News*, Newsletter (WCSA, Feb. 1, 1984) (billing the special offering for "the ladies" as a "very exciting presentation of music, gowns and dance").

121. For example, the *Cotton Digest International* has maintained a focus on industry personalities. In the past, typical covers displayed the portraits of association executives, and a short bio was printed somewhere in each issue. An edition of the Digest devoted to the Diamond Anniversary of ACSA included a history of the association — a list of its presidents, with photographs — and a quiz entitled *Bits and Pieces About ACSA Presidents and Personalities*. COTTON DIGEST INT'L 37, Vol. 58, No. 12 (May 12, 1984). Questions from the quiz included the following: "Which ACSA President graciously accepted the President's gift of a silver service, returned home and turned it in for a pair of bird dogs?"; "Which ACSA President, corrected extensively while reading a resolution from the Chair, threw his pencil down in disgust and said, 'O.K., some of you educated sons-of-bitches write it?'" For several years, a column called *Facts, Fiction and Rumors* reported retirement regrets, see, e.g., *Facts, Fiction and Rumors*, COTTON DIGEST INT'L 38, Vol. 50, No. 33 (April 8, 1978) (mourning the loss of WCSA's executive vice-president, Dick Doan, who "is hanging them up after more than a decade of service on the job. He'll be missed! When Dick (and his wife) arranged a convention, they included wax for the dance floor"), tidbits on social events, see, e.g., *id.* (exclaiming: "Man, this is (or was) a busy week-end: Conventions in Costa Mesa, Charleston, Austin, followed a few days with meetings in San Francisco and Hot Springs. A man could stay loaded (from drinks) and broke (from expenses) trying to make all of them"), and legislative rumors, see, e.g., *id.* ("As for farm bill changes, looks like Secretary Bergland and the administration are trying to 'cut them off at the pass,' with the 10 per cent acreage diversion plan. But congress will be back this week, and they'll have the final word on farm legislation."). In earlier years, the magazine *Textile Industries* had a column called *Personal Notes about Men You Know* containing similar sorts of information.

122. Telephone Interview with Merchant #8 (July 1996); Telephone Interview with Mill Association Executive (Oct. 1996) ("The identity of merchants is important. [There is] tremendous loyalty between mills and merchants who literally know one another and are friends who work together in their relationship.").

123. See *supra* text accompanying notes 113-119; Donna Rogers, *Original Blackboard Discovered During Restoration*, AUGUSTA CHRON., (June 21, 1996), available at <http://www.cris.com/~pgarber/exchange.html>. ("Besides serving as a place of business, [until the 1920s, the Augusta Cotton Exchange] was a place to play checkers, gamble and visit

These gossip networks remain active today. As transactors explain, "Front Street [the main cotton trading street in Memphis] is worse than a bunch of old women;"¹²⁵ "it is like a sewing circle;"¹²⁶ "most breaches of a serious nature are known within a day."¹²⁷ These networks are so effective that "[m]ost [transactors] know of each other or can call someone that is in the region to verify some information on a person/firm they are considering doing business with. They rely on past experience/knowledge of that person/firm."¹²⁸

Over time, cotton institutions also began to encourage the emergence of a less personal form of trust, information-intermediary based trust. They created formal methods for transmitting reputation information,¹²⁹ such as circulars reporting the names of transactors who refused to arbitrate or to comply with an award rendered against them, and, in some associations, information bureaus. At the ACSA, for example:

Members desiring information as to the moral integrity, ability to judge cotton, or financial responsibility of any cotton firm or commission buyer in the cotton belt may ask the Secretary to secure this data for them. The information is obtained, in confidence, from sources which [ACSA] be-

during the day and witness cockfights and bet on football games after hours — a man's getaway, because women were not allowed."); MCE Merchant Survey, Respondent #6 (Jun. 17, 1997) (listing "social benefit" as a main benefit of MCE membership); Wayne Risher, *Museum may be in Future of Cotton Exchange*, COM. APPEAL, Feb. 11, 1999, at CC1 (describing the MCE as "a rule-making body and a social organization," and noting that it was "a big component of the story of why Memphis is what it is, socially and economically").

124. See Risher, *supra* note 123; *Times Change for Memphis Cotton Mart*, SAN DIEGO UNION TRIB., April 25, 1989, at AA10 (noting that in the past, "buyers and sellers packed into the downtown Cotton Exchange [in Memphis] to haggle over prices or trade gossip").

125. Telephone Interview with Merchant #1 (no date).

126. Telephone Interview with Mill Representative #1 (Apr. 2, 1997).

127. Telephone Interview with Merchant #5 (no date).

128. Email from Association Administrator, to Mary LaBrec (Nov. 15, 2000, 9:45:21); see also Telephone Interview with Merchant #6 (no date) ("We [the cotton industry] learn about [transactors' reputations] from constantly talking with people and trading with people. Information is passed word of mouth from friend to friend. We all know if there is a problem person.").

129. Several private publications aided in this effort. One such publication was *The International Cotton Buyer and Cotton Seller and Reference Book*, which, according to an advertisement for the work, furnished "information regarding the financial responsibility of cotton shippers and exporters in America, as well as the selling agents and merchants abroad," but did not, like many similar publications in this or other industries, "depend upon correspondence or run lists of dead names. We send high-priced and competent men to every town in the South with enough cotton to sustain one shipper or exporter. These men procure the information necessary to the rating of these shippers or exporters while on the ground." COTTON FACTS 210 (1926). Another such publication, *The American Wool and Cotton Reporter's Guide*, also provided credit-related information. The 1950 edition included information on many companies including the number of employees, the amount of capital, balance sheets, and earning statements, as well as each company's name, address, products, and company contacts.

lieve[s] to be accurate and authentic; it is passed on to the inquiring member without identifying the source of such information.¹³⁰

These association-sponsored information channels were also supplemented by an active trade press that covered all aspects of the industry's operation as well as by information provided by the banks who financed most of the industry and were quite willing to share general credit worthiness and other soft information about their customers with market participants.¹³¹ However, despite the creation of these formal and informal information intermediaries, social trust-based reputation sanctions remained important.¹³² Today, the industry continues to rely on both social trust and information intermediary-based trust to support exchange. As one mill association executive explained:

In the past, a lot of cotton was sold on a handshake, with no documentation. This tradition has changed; still many transactions continue to be done on the basis of reputation and your word. Having a buyer-seller relationship you are proud of continuing with, with someone you like socializing with, is still important. The old ways are the silent partner of the written agreement; there is a real desire to work out problems.¹³³

130. http://www.acsa-cotton.org/Become_a_Member/become_a_member.html; see also TCA BY-LAWS, *supra* note 72, at Art. VII, § 7-8, 10 (authorizing the creation of a "Bureau for Exchange of Confidential Information," requiring that "[a]ll members of the Association shall hereafter report to the Secretary . . . any unsatisfactory transaction had with any person, firm or corporation engaged in the business of buying or selling cotton . . . and upon request of the Secretary . . . members shall furnish any and all information which they may have touching the credit, qualifications, character and general reputation of any such persons, firms or corporations," and granting all members access to the information); REPORT OF THE SEC'Y TO FIFTH ANNUAL CONVENTION OF THE ATL. COTTON ASS'N (April 2-3, 1928) ("I wish to take this opportunity of suggesting that when our members take on a connection with a firm with whom they are not thoroughly familiar that they make inquiry of the Association regarding them. Precaution of this nature will probably result to the benefit of our members."); REPORT OF THE SEC'Y TO THE SIXTH ANNUAL CONVENTION OF ATL. COTTON ASS'N (April 2-3, 1929) (noting in connection with the previous year's suggestion that members contact the association for reputation-related information that, "[m]any of our members have made inquiries, which have resulted to their benefit").

131. When asked how they got information about mills' reputations, many merchants mentioned bankers. See, e.g., MCE Merchant Survey, Respondent #4 (May 30, 1997) ("Agents, my competitors, the subjects [sic] competitors, banks, trade journals."); Telephone Interview by Connie Rogers with MCE Merchant #4 (Aug. 8, 1997) ("[M]y banker."); Telephone Interview by Connie Rogers with MCE Merchant #5 (Aug. 8, 1997) ("[B]ank references.").

132. Mill Survey, Respondent #1 (Aug. 11, 1997) (Reputation "means everything to me. A merchant with a bad reputation has little chance at business with me. No time has not changed the importance — that was part of my learning as I grew up"); Mill Survey, Respondent #4 (Aug. 6, 1997) (reputation is a "high priority and this has not changed over time"). Some older transactors, however, feel that the importance of reputation has diminished as the social ties that preserved business relationships and encouraged transactors to amicably resolve disputes have begun to disintegrate. See, e.g., Telephone Interview with Merchant #3 (no date) (observing that in the 1940s, "reputation counted for more. Today there is more emphasis on price. Back then, everyone knew our prices were higher but wanted to do business with us anyhow. We were the Tiffany of the cotton business").

133. Telephone Interview with Mill Association Executive (Nov. 1996). It is difficult to trace the demise of the purely handshake-based trade with any precision. However, an ex-

Together, the social connections and information channels encouraged by industry institutions have succeeded in making so much reputation-related information available, that reputation-based nonlegal sanctions are able to play an important, and generally positive, role in commercial transactions, a role that transactors recognize and manipulate quite explicitly.¹³⁴

B. *Benefits of Reputation-Based Nonlegal Sanctions*

The wide variety of efforts cotton industry institutions have made and continue to make to ensure that reputation-based NLSs are available to transactors, even though transactors have ready access to such an extraordinarily well-developed and well-run PLS, suggests that reputation-based NLSs may play a role in cotton transactions that the PLS cannot replicate through its formal structures. It is therefore use-

ective of the SCA noted that until 1987, most members traded on a handshake whereas now they tend to use written contracts. She attributed the shift not to any breakdown in reputation but rather to an increased bankruptcy rate in the mill sector, and merchants' realization that legally enforceable contracts were needed to preserve their rights in bankruptcy. See Telephone Interview with SCA Executive (no date). Similarly, in the diamond industry, where handshakes and intonation of the phrase "mazel U'bracha" (luck and blessings) have traditionally been used to seal deals, written consignment agreements are now sometimes used to protect the consignor's rights in the event the consignee goes bankrupt. The writings are still viewed as unnecessary as between the two parties to the agreement. Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 121-22 (1992) [hereinafter *Diamonds*].

134. The records in MCE cases reveal instances where damage to reputation appears to have been used as a threat by one or both of the parties. See, e.g., Letter between Parties indirectly involved in the case (Mar. 1, 1980), from MCE Case No. 831 (1980) ("With regard to the Quality settlement, we assure you to do best to settle pending amicably while still maintaining your reputation well in [foreign textile company's] group, i.e. . . . [foreign names], meantime, we wish that you will do utmost to push your ginners friend to settle best possible too, so that your reputation will be well maintained well in this market.") An additional communication (dated March 7) records this request: "Pls tk actn to protct ur reputatn."); Letter from Defendant, to MCE Executive Vice President and Secretary (Nov. 26, 1973), in connection with MCE Case No. 825 (1973) (Where "one of the contracts in question was called to [Defendant's] attention," and the Plaintiff told the Defendant that "we would have to take the cotton or he [Plaintiff] could not show his face on the street. He further stated that [Defendant's Memphis Rep] would not be able to trade on the street. We agreed to take the cotton and he proceeded to invoice us cotton on all our contracts"). Similar allusions to social and business reputation harm can be found in moving papers submitted to the BoA. See, e.g., Seller's Brief at 4, BoA Case No. 94 (1964) (quoting a copy of a letter from Seller to Buyer (July 27, 1964): "I believe that we should settle this dispute as gentlemen considering what is right and wrong and arriving at the dictates of our conscience . . . I would like to point out the fact that, as far as I as an individual am concerned, the outcome of our dispute placed with the Appeal Board will have very little effect on my personal life. This also is true as far as you as an individual are concerned. The real crux of the matter is — are we able to settle our differences man to man or do we have to ask outsiders who have absolutely no interest in neither [sic] your business nor my business to settle our difficulties . . . I appeal to you again to consider this dispute in the light of right and wrong and let us get along with properly being friends and business associates. This thing has caused wounds much too deep than mere money will ever justify").

ful to explore some of the ways that reputation-based NLSs complement the monetary sanctions available through the PLS.

To begin with, in the absence of these NLSs, the under-compensatory market-difference based damages provided for in the trade rules would lead to inefficiently high levels of contractual breach.¹³⁵ This is something that would be particularly undesirable in the cotton industry. As one transactor explained, “[y]ou want performance, not payment for nonperformance. [Payment] is not fulfilling your deal.”¹³⁶ And, as another transactor put it, “you do not just breach and pay. This is not done.”¹³⁷

Transactors’ attitudes towards breach of contract are understandable given the high velocity of transactions in the market as a whole, the low profit margin on most trades, and many transactors’ limited access to financing during the pendency of disputes. In such contexts, keeping the number of disputes low and minimizing the frictions and uncertainties involved in trade are essential to running a profitable concern. As one industry participant noted, “any departure from the

135. In merchant-to-mill transactions, both mills and merchants often suffer significant consequential damages that are not recompensed under trade rule damage measures if the other breaches. First, if a merchant delivers defective goods and the defect is not detected before the cotton is used, the cotton may damage machinery (which due to technological changes is becoming more sensitive to even small deviations in quality) and slow down the production process. *See, e.g.*, BoA Case No. 127 (1989) (where the “Buyer allege[d] losses resulting from increased labor costs, slow down of operations, and inferior yarn,” and while ruling on other grounds, the arbitrators noted that the “Southern Mill Rules do not provide for damages of this nature”). Second, if a merchant delivers late, a mill might be forced to suspend or curtail its production (while continuing to meet its payroll) due to the increasing prevalence of just-in-time inventory methods. Third, because merchants operate on a tight cash-flow margin, if a mill refuses a shipment, or accepts it and refuses or delays payment, the merchant may be forced to suspend or curtail its operations. Finally, whichever transactor arranged for the transportation will have to make good to the carrier, another uncompensated and often unsalvageable expense. *See* Telephone Interview with MCE Executive (Feb. 1997) (When asked why breach, even with payment of market-difference damages, upsets someone, he explained that “most of the contracts in the cash market involve a merchant buyer who has or will contract with an end-user, or are transactions directly to end-users. These end-users need to get trucks and rail cars and scheduling unloading at particular times, all of which is very complex”).

136. Telephone Interview with Merchant #9 (July 1996). The rules of several shippers’ associations and exchanges show a similar hostility to the idea that breach, even when accompanied by the voluntary payment of damages, is acceptable commercial behavior. For example, following several provisions setting out penalties for late delivery and payment, the MCE Rules state that:

It is not contemplated in prescribing these penalties [for delay] that either Buyer or Seller shall intentionally be the cause of delays in carrying out the delivery within the time prescribed and a continued or repeated violation will be the cause of the party, or parties, violating this rule, to be brought before the Board of Directors of the Memphis Cotton Exchange [and suspended or expelled from membership].

MCE TR, *supra* note 17, at R. 12, cl. 1; *see also* SMRs, *supra* note 5, at Art. V, § 26 (setting out penalties for late payment by the buyer, but cautioning that the rules do not “give buyer any right to delay payment and any failure to pay within the prescribed period will entitle seller to relief for breach of contract”).

137. Telephone Interview with Merchant #1 (no date).

'my word is my bond' method of doing business [is] viewed as introducing uncertainty into the contract process, something that is viewed as per se undesirable . . . [T]he desire to run a smooth business is key to mills and people prefer to deal with reliable folks [for whom] they are sometimes willing to take a loss."¹³⁸ Although renegotiation in certain types of situations where breach is efficient is not uncommon,¹³⁹ when it fails, transactors want to be able to rely on getting performance. As one transactor explained, renegotiation is sometimes okay, but when a mill says, "I've gotta have it now — when you have to have it, you have to have it, and the merchant generally delivers."¹⁴⁰ And, as another merchant noted, while some agreements are renegotiated willingly when doing so is mutually beneficial, "sometimes. . . the other guy is not willing to do this. He is just in a bind and will say no, and in that case, a person of integrity takes his word for it and just delivers."¹⁴¹ More generally, as a prominent industry lawyer explained, even if transactors have to forgo the benefits of an occasional profitable breach in situations where attempts to renegotiate fail, doing so is worthwhile so long as they can count on their transacting partner to do the same when the shoe is on the other foot.¹⁴²

Although the industry could attempt to regulate transactors' breach-or-perform decisions through the award of fully compensatory expectation damages, its decision to rely instead on hybrid monetary and nonlegal sanctions offers several advantages. First, as compared to a rule that provided for fully compensatory expectation damages, the use of a market-based measure of damages that does not rely on firm-specific information, reduces the cost of litigation by eliminating the need for damages-related discovery.¹⁴³ Second, the use of a market-difference based damage measure makes it unnecessary for the parties to introduce complex valuation evidence on lost profit.¹⁴⁴ Third, be-

138. Telephone Interview with ACSA Executive (Mar. 25, 1997); *see also* Telephone Interview with Merchant #3 (no date) ("Your word is your bond, and any departures from this way of looking at things bring uncertainty to the process; uncertainty of any kind is viewed as very undesirable.").

139. *See infra* note 150 (describing the industry's renegotiation norms in some detail).

140. Telephone Interview with Mill Representative #1 (Apr. 2, 1997).

141. Telephone Interview with Merchant #4, retired BoA arbitrator (Mar. 1997).

142. Telephone Interview with ACSA Executive (no date).

143. Since lost profit is a key component of fully compensatory expectation damages, and it is calculated by reference to revenues less costs, discovery is needed to ensure accuracy. In the absence of discovery, a plaintiff would have an incentive to introduce evidence that overstated revenue and understated costs in ways that would be difficult, if not impossible, to detect.

144. *See generally* ROBERT L. DUNN, MASS. CONTINUING LEGAL EDUC., INC., RECOVERY OF DAMAGES FOR LOST PROFITS (5th ed. 1998) (discussing the wide variety of information relevant to proving lost profit under the numerous valuation methods accepted by some courts); 2 ROY RYDEN ANDERSON, DAMAGES UNDER THE UNIFORM COMMERCIAL CODE § 11:27 (1991).

cause the damages that would be awarded in arbitration can be calculated by both parties shortly after breach,¹⁴⁵ the likelihood of pre-arbitration settlement is higher than it would be under an expectation measure. Finally, and perhaps most importantly, by adopting a damages provision that does not condition on firm-specific information, the trade rules enable transactors to avoid revealing certain types of information that they prefer to keep private. In cotton transactions, transactors' interest in keeping certain information private (their "secrecy interest")¹⁴⁶ may, in some instances, be even stronger than their interest in receiving full compensation for their losses in a particular dispute (their "compensatory interest").

Consider, for example, a contract between a merchant and a mill who, as is quite common, either transact on a repeat basis or enter into numerous different, but overlapping, contracts, each of which is for installment delivery over a period of months. At the time any one of these contracts is breached, the mill would not want to reveal its cost structure, profit margin,¹⁴⁷ shipping arrangements, the identity of the other merchants it buys from, or other information relating to its vulnerability to non-delivery, to either the merchant or the market as a whole, something it would need to do to recover fully compensatory expectation damages as traditionally defined. Revealing this information might give the merchant additional bargaining power in subsequent transactions. It might also enable him to engage in hold-up with respect to other outstanding executory contracts between the parties, since, among other things, he would know the mill's vulnerability to non-delivery.¹⁴⁸ For example, if a merchant who had entered into sev-

145. The SMRs require the aggrieved party to get three actual price quotes within three days and give the breaching party five days to respond with payment. See *supra* note 45.

146. For a detailed discussion of how the existence of a "secrecy interest" might affect transactors' litigation decisions, contracting decisions, breach-or-perform decisions, and suit or settlement decisions, as well as the desirability of various damage measures, liquidated damages, and specific performance, see Omri Ben-Shahar & Lisa Bernstein, *The Secrecy Interest in Contract Law*, 109 YALE L.J. 1885 (2000).

147. Telephone Interview with Merchant #11 (2000) (describing mills' and merchants' profit margins as "very private information").

148. Similarly, because many merchant-to-merchant contracts are between competitors, a merchant would not want to reveal his profit margin or, more importantly, the identity of the mills and other merchants to whom he sells, both pieces of information that would be needed to properly calculate the expectation measure. See Telephone Interview with WCSA Executive (July 1996) ("The arbitrators at the WCSA do write opinions, but these opinions are only given to the parties. The Board has, on numerous occasions, considered and rejected proposals to publicize arbitration results. . . . [taking the position that] because most disputes are among competitors, and most deals are kept secret, so should the results of arbitrations."). Although liquidated damages clauses might seem to provide an alternative solution to this problem, the process of bargaining for them often reveals information. See Ben-Shahar & Bernstein, *supra* note 146, at 1902-04 (discussing the information-revelation and secrecy-compromising effects of bargaining for liquidated damages clauses, and demonstrating that, while they are not as severe as those associated with seeking expectation damages, they may nevertheless be significant).

eral forward contracts with a mill for “old crop” cotton learned a month before delivery on the last contract that the mill needed only old crop to produce the last shipment of a particular kind of cloth for a valued customer, and the merchant knew that old crop was not readily available on the open market, he might threaten not to deliver the cotton to the mill unless it agreed to pay a higher price. More generally, in the cotton industry, most firms are privately held and are extraordinarily reluctant to release basic balance sheet information to anyone but their bankers. In such contexts, if expectation damages were the only remedy available, and a merchant contemplating breach knew that a potentially aggrieved mill was likely to have a substantial “secrecy interest,” the merchant might view the mill’s threat to sue in the event of breach as incredible and therefore breach in situations where it was inefficient for him to do so.¹⁴⁹ In contrast, if, as in the cotton industry system, the aggrieved mill had the right to obtain a measure of damages that did not require it to reveal any firm-specific information, its threat to sue would be credible. In such situations, if the merchant breached, the mill would go to arbitration and collect market difference damages, whereas under a regime of fully compensatory expectation damages, it would not sue and would therefore obtain no recovery. The market-difference-based measure of damages therefore protects both the mill’s secrecy interest and its compensatory interest better than the fully compensatory expectation measure. However, because the market difference measure is so under-compensatory, it would not, standing alone, adequately deter breach. This is one of the most important reasons industry institutions have gone to such lengths to maintain the availability of reputation-based NLSs.

In practice, across the market, NLSs supplement the damages available in arbitration so that a cotton transactor contemplating breach is well aware that he must take into account both the monetary damages he will be ordered to pay and the reputational harm he will suffer. As a consequence, if these NLSs are high enough (and, in practice, it seems that they are), the system of sanctions as a whole may discourage inefficient breach, and, because renegotiation is not un-

149. Alternatively, the industry could try to set the damage measure (perhaps through manipulation of the per-pound penalty) at some approximation of “average expectation damages” so as to provide more efficient breach or perform incentives. Indeed, it is possible that this was the original intent of SMR drafters. However, as the minutes of the ATMI-ACSA Joint Meetings from 1947-1990 suggest, raising the penalty amount has proved to be extraordinarily difficult, since an increase would be more beneficial to mills than to merchants. As a consequence, augmenting these monetary remedies with NLSs may have been the best available way to increase the sanction faced by a would-be breacher. For an extended discussion of the desirability of awarding average expectation damages in a context where one or both transactors have a secrecy interest, see Ben-Shahar & Bernstein, *supra* note 146, at 1894-96.

common, the loss from inefficient over-performance is unlikely to be large.¹⁵⁰

150. In theory, the use of NLSs to supplement monetary sanctions may lead to inefficiently high levels of performance, because it is difficult for the transactor imposing them to accurately calibrate their size. In practice, however, in the cash cotton trade, high levels of contractual performance are considered desirable by market participants and voluntary renegotiation is considered appropriate (though *not* obligatory), in the contexts where the gains from efficient breach are likely to be the largest and most frequent. More specifically, the cost of renegotiation is lowest in situations where breach is efficient due to an increase in the seller's cost of performance that is attributable to a market-wide or regional event, like bad weather that makes cotton of a particular quality largely unavailable. As one merchant explained, "[y]ou don't breach with a mill. There are exceptions; if you contract for a particular kind of cotton a year in advance, and then everyone knows little of the quality was produced, there will be an adjustment." Telephone Interview with MCE Executive (Feb. 1997). In such situations, because the event that triggered the increase in the cost of performance is both outside the seller's control and observable to the buyer, requesting renegotiation is not perceived to be opportunistic and is not damaging to a seller's reputation. *See, e.g.*, Telephone Interview by Renée Liu with MCE Merchant #15 (Aug. 1997) (noting that he is willing to "renegotiate if the quality of cotton [contracted for] is not grown"); Posting of Participant, to Cotton-L@listserv.aol.com (Jan. 27, 1998) ("Most of the cotton we book is on a 75% pre-harvest fixation, and the merchants are typically very understanding about crop failures or failure to plant due to weather as long as they are notified as early as possible."). Indeed, a mill (or a large regional merchant vis-à-vis a producer) that insists on performance in such circumstances may find it more difficult to purchase on the forward market for a significant period of time. For example, one year in the early 1990s, many merchants and mills entered into contracts to deliver cotton of a particular micronaire (a feature of quality) that turned out not to be plentiful in the crop due to weather conditions. This resulted in a large increase in the price of that type of cotton. If mills had insisted on delivery, it would have imposed huge losses on merchants. Many mills, however, worked with their merchants and agreed to take delivery of a different type of cotton at a different price. There were, however, some mills that either could not or would not make these types of adjustments. As a consequence, merchants became reluctant to enter into long-term contracts with these mills, although they remained willing to enter into short-term contracts with them. Telephone Interview with Mill Representative #1 (Apr. 2, 1997).

On the other hand, proposing renegotiation when an opportunity to sell to a higher valuing purchaser arises is considered more problematic, perhaps because the amount being offered by the higher valuing user is largely unobservable to the original buyer. *See, e.g.*, Telephone Interview by Connie Rogers with MCE Merchant #3 (Aug. 8, 1997) (explaining that he "would not renegotiate a contract because the seller found a better price. Word is important"); Telephone Interview by Connie Rogers with MCE Merchant #4 (Aug. 8, 1997) (explaining that he "wouldn't renegotiate because the seller [farmer] found a better price because I have already sold the cotton elsewhere and am obliged to deliver it"). However, profitable opportunities to sell to a higher valuing purchaser are uncommon. *See* Telephone Interview by Connie Rogers with MCE Merchant #2 (July 18, 1997) (noting that the opportunity to make money by selling to a higher valuing purchaser "doesn't happen very often"). Cotton is generally available on spot markets. When it is not, as the price increases, the value of the goods increases to all purchasers simultaneously, making breach and resale to a higher valuing third-party largely unprofitable after the payment of damages. Telephone Interview with Merchant #1 (no date). Although most transactors strongly condemn routine renegotiations that are proposed to facilitate sale to a third-party, in the rare instances where the gains from renegotiation in such contexts are particularly large, transactors do in fact renegotiate, typically splitting the surplus, especially where they have a long-standing relationship. *See, e.g.*, Telephone Interview by Connie Rogers with MCE Merchant #7 (Aug. 8, 1997) (expressing reluctance to be bought out of a contract, but noting that he "guess[es]" that he would be willing to be bought out in some circumstances, but adding that "[i]t depends on the person or relationship. If the person was a constant pain to deal with, I wouldn't. But with a good relationship, I'd be more willing"); Telephone Interview with Merchant #1 (no date) (discussing a time when a new employee of his sold cotton very cheaply, someone else offered a lot more for it, and they renegotiated).

The second major benefit offered by the industry's decision to maintain the availability of NLSs is that it enables transactors to enter into extralegal understandings that are backed by NLSs and are therefore likely to be performed over a range of market conditions. These extralegal understandings can add significant value to contracting relationships. Even when contracting within the industry's well-run PLS, there is a limit to the amount of value that transactors can create through the use of legally enforceable contract provisions. Rational transactors will only agree to legally enforceable commitments that condition on verifiable information — that is, information that from an *ex ante* perspective transactors would find it worthwhile to prove to a third-party in the event of a dispute. Although the PLS's use of expert adjudicators makes more information verifiable than would be verifiable if cotton contracts were adjudicated in court, the need for legally enforceable contract provisions to condition on verifiable information remains a significant constraint on transactors' ability to create value-maximizing contract governance structures. Although some verifiable information is also observable, sometimes the most desirable contract provision conditioning on verifiable information will condition on information that is either not observable or is more costly to observe than the information required for a provision that conditions on information that is only observable. As a consequence, when transactors are able to supplement their legally enforceable contracts with extralegal understandings that condition on information that is observable to them but may not be verifiable by a third-party,¹⁵¹

In sum, despite the strong condemnation of unilateral breach, voluntary adjustments are not uncommon. As one transactor explained, "the reason for . . . requesting an adjustment is key. If there is a good reason, a shortage, financial problem, etc., the other guy will typically work with you on the problem. On the other hand, if you were to sell to someone at a higher price, and this ever became known, which it would very fast, no one would want to deal with you." Telephone Interview with Merchant #5 (no date).

151. Indeed, a comparison of the importance of reputation-based and other NLSs in diamond, cotton, and grain markets (all of which are governed by PLSs) suggests that the importance of these sanctions is closely linked to the importance to the value of a standard transaction of provisions that condition on information that is observable but not verifiable. Although the types of events that can disrupt a cotton or grain transaction are similar, reputation is far more important in the cotton market. As one merchant observed, "[r]eputation is still as important to doing business [in the cotton industry] as it was 30 years ago, far more so than in grain." Telephone Interview with Merchant #7 (no date); *see also* Bernstein, *Merchant Law*, *supra* note 60 (presenting a case study of contracting relationships in the grain and feed markets). Unlike grain, which can be objectively graded, cotton is graded on a highly subjective basis. Cotton buyers must therefore rely more heavily than grain buyers on a seller's integrity for delivering the quality promised, especially where the sale is concluded over the phone. Even when cotton is sold on USDA type, the seller's reputation may remain important to the buyer since there are nuanced aspects of quality that are not fully taken into account in official descriptions. More generally, until the introduction of the more objective HVI classing method a few years ago, even a more detailed contract description of the quality of cotton promised would not have been even a partial substitute for the seller's reputation for accurately describing goods. Reputation is even more important in diamond markets than cotton markets, at least in part because there are even more aspects of a diamond contract that cannot be adequately dealt with through state-contingent contracting.

they can create more valuable contract governance structures than they could create if the extralegal sanctions that support these understandings were unavailable.¹⁵²

Moreover, the availability of these NLSs may also increase the value of the terms of transactors' written contracts, not only by augmenting the damages imposed in arbitration, but also by making it more likely that interior contractual provisions — that is, provisions whose violation, while costly, would nevertheless not make it worthwhile to bring suit — will be performed.¹⁵³ Given the low profit margin in most cotton transactions and the large number of these interior provisions (mostly relating to quality and delivery terms), increasing the likelihood that they will be performed, while at the same time reducing the frictions of trade, can add significant value to contracting relationships.¹⁵⁴

In sum, the cotton industry has succeeded in creating a private legal system and a social and informational infrastructure of trade that improves on the substantive rules and adjudicative procedures in the public system and is well-designed to maximize the value of transactors' legally enforceable and legally unenforceable commitments. Yet

For example, it may not even be possible to describe a rough diamond with sufficient precision to enable a third party neutral to determine whether or not the stone contracted one day is actually delivered another day; yet a buyer will know if the stone delivered is not the stone contracted for. In a diamond transaction, reputation is also used to bond the seller's warranty that the stone has not undergone one of several treatments to disguise flaws. Although these flaws can be detected through laboratory tests, the tests are too expensive to use in every transaction. See Bernstein, *Diamonds*, *supra* note 133, at 115.

152. See Benjamin Klein, *Why Hold-Ups Occur: The Self Enforcing Range of Contractual Relationships*, 34 *ECON. INQUIRY* 444, 455 (1996) (arguing that there is a "fundamental complementarity between court enforcement and private enforcement. . . . The two enforcement mechanisms work better together than either of them do separately").

153. In the absence of NLSs, if only monetary damages were available, interior contract provisions might not be performed, because while breach of interior provisions imposes costs on the promisee, these costs are small in relation to the value of the transaction (and perhaps the contracting relationship) to the parties, making any threat to sue if such a provision is violated incredible. As a consequence, breach of these provisions would be common and a lot of contractual value would be lost. However, when NLSs are available, and can be imposed even after a transaction has been completed (and at a much lower cost than money damages), the threat to impose them for breach of an interior provision is more likely to be credible, and the provision is therefore more likely to be complied with.

154. Although reputation-based NLSs in the cotton industry are strong, they would not create nearly as much value in the absence of the PLS and would not, standing alone, be able to support efficient levels of trade or induce efficient breach-or-perform decisions. The PLS's money damages, while under-compensatory, do succeed in bonding the price-risk aspect of cotton contracts by ensuring that a mere change in the price level will not make breach attractive. Given the volatility in cotton prices over the length of a typical relationship, it would be difficult, if not impossible, for the industry to create reputation-based NLSs that were strong enough to control the price-risk aspect of transactors' behavior. Moreover, the existence of the PLS puts a check on the amount of damage baseless gossip can cause, since at a certain point, the person being gossiped about can defend himself by pointing out that because the gossiper has not taken him to arbitration, his actions could not have been so bad.

to fully understand the reasons that the industry has found it advantageous to opt out of the legal system, it is useful to consider how the system as a whole is structured to create the conditions under which cooperative contracting relationships are most likely to arise and endure.

III. FACILITATING COMMERCIAL COOPERATION

1. *Conditions for Creating Cooperation*

One of the most striking aspects of the cotton industry's PLS is the small number of disputes requiring third-party adjudication. The BoA and the MCE each decide an average of only two cases a year.¹⁵⁵ This relatively small number of arbitrations,¹⁵⁶ combined with evidence that the incidence of work-a-day contractual opportunism is low,¹⁵⁷ that most transactional relationships are long-term and repeat, and that contracts tend to be renegotiated when doing so leaves both transactors significantly better off,¹⁵⁸ suggests that one of the more important ways that cotton industry institutions create value is by providing a social and institutional transactional framework that effectively constrains opportunism and promotes commercial cooperation in its shadow.¹⁵⁹

Supporting the emergence and maintenance of repeat-dealing cooperative contracting relationships is particularly important in indus-

155. Despite the small number of cases arbitrated by the MCE, its member merchants consider arbitration to be an important benefit. When twenty-two MCE members were asked whether arbitration was an important benefit of membership in the exchange, ten answered "yes" and twelve did not reply to the question.

156. The SCA and the ACA arbitration tribunals each hear less than one case per year, Telephone Interview with SCA and ACA Executive (Oct. 2000); the WCSA arbitration tribunal hears three to four cases a year, Telephone Interview with Merchant #8 (no date); and from 1993-95, the TCA heard about three cases per year, Telephone Interview with TCA Executive (no date).

157. See Telephone Interview with Merchant #6 (no date) ("I've been in the business near sixty years and there are only two or three people I won't deal with anymore, and they are people who were marginal to begin with."). See generally BUSH, *supra* note 113, at 436-37 ("Over the generations, the cotton business has been exceptionally honorable, with the trite but true aphorism of a man's word being his bond applying equally to mills and agents, merchants and farmers. . . . considering the tens of thousands of transactions taking place in any given year, and the millions of bales sold, transgressions were remarkably rare. As a result, the cotton business operated in an aura of trust without which it could ill function: two parties to a contract could make commitments at a firm price as much as a year or more in advance, and there was never any question that both parties would live up to the letter and spirit of the contract, thus enabling each other to plan future actions within an established framework.").

158. See *supra* note 150 and accompanying text.

159. See *supra* notes 73-87 and accompanying text (discussing several features of the PLS that encourage settlement and decrease the likelihood that misunderstandings will arise).

tries like cotton where prices are volatile, transactional velocity is rapid, profit margins are slim, and execution costs, that is, the transaction costs of performing the contract, tend to decrease over the life of a contracting relationship (particularly in merchant-to-mill relationships) as transactors become more familiar with one another's business needs, standards, and operations.¹⁶⁰

This Part explores the many features of the cotton industry's PLS that, together with a variety of activities sponsored by industry-run institutions, as well as some social and economic path-dependent features of the transactional setting, have succeeded in creating the types of conditions that are generally associated with the emergence of sustainable cooperation among market participants.¹⁶¹

In general, in order for cooperation to emerge in a particular market, transactors must each adopt strategies of cooperating at the beginning of each contracting relationship and thereafter responding to

160. There are numerous sources of execution costs savings in repeat-dealing relationships. For example, when a merchant has sold to a mill for years, and the mill's quality needs have remained stable, the merchant will know the quality range of cotton that the mill will be able to use. As a consequence, if the merchant consistently delivers quality in this range, the mill may no longer feel the need to spend the money to class (that is, to grade and inspect) its deliveries. This can result in significant cost savings, some of which are passed on to the merchant in the form of a higher price. Telephone Interview with Merchant #11 (no date). Another important component of execution costs is coordination costs. As one mill buyer explained, these costs are now more important due to consolidation on the merchant and mill sides of the business, which has given rise to a "need to coordinate more in terms of deliveries since there are coordination problems . . . [you need greater precision in getting bales from warehouse to mill . . . as mills have become larger, the timing and scheduling of deliveries has become a more complex operation, and this is now part of the merchant's reputation." Telephone Interview with Mill Representative #1 (Apr. 2, 1997). The significance of the problems caused by lack of coordination and/or standardization in delivery times and practices is also evident from the minutes of the annual ACSA-ATMI joint meetings. The need for some rules and regularities in this area is a regular subject of discussion, and while no rules on the subject have been adopted, both associations have repeatedly agreed to circularize their members about the contours of acceptable behavior. See, e.g., Minutes of the ACSA-ATMI Joint Meeting (1976) (where the ACSA again requested cooperation from the ATMI in "urging their members to receive cotton five days a week, thus utilizing to a greater degree our transportation facilities," and the mills' representatives responded that they were glad to recircularize this message). Finally, as compared to dealing with a new transactor, an additional advantage of dealing with the same firm on a repeat basis is that it may be easier to detect financial distress. When a firm is familiar with another firm's payment patterns in situations where it is not in distress, and understands more about other aspects of its operations, it is more likely to be able to detect deviations from its usual practices that indicate financial trouble.

161. For more formal discussions of the emergence of cooperation and compliance with arbitral awards in historical merchant-run PLSs, see Paul R. Milligram et al., *The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs*, 2 J. ECON. AND POL. 1 (1990) (describing the institutions that resolved disputes and enforced arbitral judgments in the medieval Champagne fairs and demonstrating that "[e]ven in a community in which any particular pair of people meet rarely, it is still possible . . . for an individual's reputation in the group as a whole to serve as a bond for his good and honest behavior toward each individual member"); Avner Greif et al., *Coordination, Commitment, and Enforcement: The Case of the Merchant Guild*, 102 J. POL. ECON. 745 (1994) (drawing on formal models of repeat play games to explain the operation of merchant guilds in the late medieval period).

cooperative behavior with cooperation and responding to uncooperative behavior (defection) with punishment (such strategies are called "tit-for-tat" strategies). Each transactor must also be able to obtain information about the reputations of other market participants, and reputation must be at least partially dependent on how a transactor behaved in previous transactions. In addition, each transactor must be able to observe whether the person he is dealing with has cooperated or defected.

Cooperation can emerge under these circumstances because transactors have an incentive not to behave opportunistically. Although a transactor can still obtain a short-term benefit from defection, he will realize that an act of defection will likely trigger a sequence of non-cooperative responses (most likely, refusals to deal) both from his transacting partner and, depending on the type of breach, from a certain number of other market participants. Because these noncooperative responses tend to reduce his future trading opportunities, the long-run cost of defection will often be greater than the short-term gain from defection, so a transactor who is not in financial distress is more likely to cooperate than to defect.¹⁶²

In essence, when information about past transactional behavior is available to a significant number of participants, breach of contract as to one transactor is transformed into breach of contract as to numerous market transactors for the purposes of a transactor's commercial reputation. As the reputational penalty for breach of contract increases, more commercial commitments are transformed into self-enforcing obligations,¹⁶³ and cooperation can emerge as a long-term equilibrium.

2. *Creating Conditions that Promote Cooperation*

In the early days of the cotton industry, the types of trusting interpersonal relationships that created an initial expectation of cooperative behavior were common. In the Old South, the culture of honor was strong. "Laying down on a contract" or violating the maxim "my word is my bond" would result in social as well as economic ostracism.¹⁶⁴ As a consequence, even in transactions between strangers,

162. In addition, the ability of the aggrieved transactor to credibly threaten to seek a monetary recovery through an arbitration proceeding reduces the short-term benefit of defection. It therefore reduces the incentive to engage in opportunistic behavior, as well as the magnitude of the reputational penalty required to induce cooperation.

163. For a more formal discussion of self-enforcing contracts, see generally Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981).

164. See generally SHIELDS MCILWAINE, *MEMPHIS DOWN IN DIXIE* 293 (1948) ("A man's word had to be good on Front Street and that's still true. But until recent years the Memphis trade couldn't have been conducted on any other basis, since there were no written contracts or legal binders. A trader simply said to a factor, 'I'll take that stuff at nine and a

each transactor had a well-founded reason to believe that if he acted honorably (that is, cooperatively), his transacting partner would do the same. As one merchant explained, the market evolved “as an old boy network, a club of sorts. There was this idea that a Gentleman’s honor is his bond. Period. Once it started this way, anyone who didn’t honor his word would not get any business.”¹⁶⁵

Today, while transactors engage in more pre-contractual investigation than they used to, this initial expectation of cooperation remains common. The industry’s active gossip networks continue to provide valuable reputation-related information.¹⁶⁶ Transactors can supplement this information by making inquiries of industry bankers and by using the information bureaus maintained by some of the associations. In addition, because the associations’ membership rules, voting rules, and application procedures are designed to screen out untrustworthy or financially shaky transactors,¹⁶⁷ the mere fact of association membership communicates valuable information about a transactor’s willingness and ability to meet his commercial obligations. As MCE members explained, when dealing with another member you have “the feeling of security in dealing with someone who is supposed to be responsible [sic];”¹⁶⁸ membership “shows a standard of ethical performance and acceptance by your peers as an acceptable trading part-

quarter.’ The factor jotted it down in his memorandum: 1500 bales, 9¼; the buyer, the same in his. Or they trusted their memories until the sale was put in the account books. And woe unto the man who claimed to have misunderstood the oral sale or was found guilty of dishonest dealing. Mr. Bill remembers that the Exchange expelled a man, and that the trade ostracized him, for selling reginnings for regular cotton.”)

165. Telephone Interview with Large Merchant, Merchant #7 (June 1997).

166. Email from Large Cotton Merchant, to the author (Oct. 30, 2000) (“Reputation is EVERYTHING . . . The cotton industry is a very small industry. Within any sector and any region, a substantial number of the industry is personally acquainted. So initial reports move by word of mouth.”).

167. The membership applications used by associations and exchanges require applicants to be sponsored by several current members. *See, e.g.*, SCA Application For Membership, attached to SCA Directors’ Letter No. 106 — 1983/84 (Mar. 21, 1983) (requiring each applicant to be sponsored by three members in good standing, or five members if the applicant has been in business for less than one year). Applicants are also required to establish that they are of good character and commercial standing, and to provide detailed financial information. For example, the TCA application requires applicants to, among other things, answer the following questions: (1) “State your experience in the cotton industry, include firms you have been associated with or employed by, functions performed, reasons for leaving such employment, and references who may be contacted regarding your experience and qualifications;” (2) “Have you ever filed for reorganization under any of the several chapter proceedings of the Federal Bankruptcy Act? . . . Explain the status of any such proceeding . . . Are there any unpaid past due claims, or claims in controversy, now outstanding against you? (If so, please give particulars).” In addition, the form asks the applicant for “[t]he name of your bank,” and the “name of the bank officer authorized by you to discuss your financial ability to engage in the cotton business.” TCA Application For Membership, attached to SCA Directors’ Letter No. 106 — 1983/84 (Mar. 21, 1983). Similar application forms are used by other associations.

168. MCE Merchant Survey, Respondent #5 (no date).

ner;¹⁶⁹ it is “like a fraternity.”¹⁷⁰ As a consequence, when two association members trade with one another, each is likely to begin the contracting relationship by cooperating and thereafter to respond to cooperation with cooperation.¹⁷¹

More importantly, however, by joining an association, a transactor implicitly binds himself to make more aspects of his commercial behavior in future transactions observable to market participants. All merchant associations and exchanges require members to arbitrate disputes with other members and the outcomes of most cases become quickly known within the association or exchange.¹⁷² Members who either refuse to arbitrate when they are obligated to do so or who do not comply with an award rendered against them may be either suspended or expelled from their exchange or association, and will have their names posted at the exchange and/or mentioned in the association’s newsletters.¹⁷³ Transactors who are suspended or expelled from a re-

169. MCE Merchant Survey, Respondent #3 (May 27, 1997); *see also* Telephone Interview by Connie Rogers with MCE Merchant #1 (no date) (noting that membership in an exchange gives a merchant an “aura of respectability,” and “lend[s] strength to [his] reputation,” in part because the “standards are reasonably high for membership, so [it] is evidence of a company with high standards, integrity”); Telephone Interview by Connie Rogers with MCE Merchant #6 (Aug. 8, 1997) (an important benefit of association membership is “to define who you do business with . . . The exchanges encourage members to do business only with other members”); Telephone Interview by Connie Rogers with MCE Merchant #7 (Aug. 8, 1997) (“[Membership] gives [you] some legitimacy.”).

170. Telephone Interview by Connie Rogers with MCE Merchant #6 (Aug. 8, 1997).

171. The membership rules also create an incentive for some nonmembers who are dealing with members to be true to their word. Because association membership is a valuable business asset, most nonmembers hope to be admitted to membership. However, because only a few votes are needed to block a candidate’s admission, *see* MCE BY-LAWS, *supra* note 10, at Art. VII, § 1, nonmembers are particularly wary of breaching contracts with members. As a consequence, a member dealing with a nonmember also has a reasonable expectation that the nonmember will behave honorably at the outset of a contracting relationship.

172. *See* Telephone Interview with Merchant #1 (no date) (noting that at the MCE, although “opinions may not be published or any information about the arbitration given out . . . it [the result] does become generally known”); Telephone Interview with MCE Executive (no date) (same). At the MCE, seven arbitrators hear each case, which ensures that 7.7% of the ninety member firms learn the result. In addition, the nine officers and directors who sit on the board will also know the results. If these board members are all from different companies, 17.7% of member firms will learn the information even though it is not published and even if no gossiping occurs.

173. In addition, association circulars sometimes report suspensions for reasons other than failure to arbitrate or comply with an award, *see, e.g.*, ACA Circular Letter No. 18 — 1992/1993 (Apr. 7, 1993) (reporting an ACA suspension for non-payment of bale fees), or resignations under suspicious circumstances, *see* Letter to ACSA Members from General Counsel (Aug. 20, 1996) (advising that the resignation of [name of a shipper] “came within two days of their being advised that pending quality and weight claims, on shipments to the People’s Republic of China, had been brought to the attention of ACSA by the U.S. agent of the buyer and that ‘if requested an immediate review will be undertaken by the Rules, By-Laws & Fair Practices Committee pursuant to ACSA Special Rule 18’ ”). The Southern Cotton Shippers Association. [early name of the SCA] also adopted the practice of publishing the names of members delinquent in paying dues. *See, e.g.*, Minutes of the SCSA Annual Meeting (April 28, 1943).

gional shippers' association will also have their membership in the ACSA either "suspended or terminated," and the ACSA will notify all of its individual members and all of the other regional associations of its decision.¹⁷⁴ It is also likely that a transactor who is suspended or expelled from one shippers' association for these reasons will be suspended or expelled from other shippers' associations he belongs to. Three of the four regional shippers' associations make "any willful refusal to abide by any final arbitration or award made by this Association, or by any other Association or Exchange,"¹⁷⁵ grounds for suspension or expulsion. This provision for the reciprocal enforcement of suspension and expulsion decisions, with the attendant publicity provided by each association, greatly increases the magnitude of the expected reputational effect of these sanctions. As a consequence, transactors who are suspended¹⁷⁶ or expelled may suffer so much reputational harm that they will be unable to remain in business. Although most transactors are willing to deal with nonmembers (albeit somewhat reluctantly and on slightly different terms) as long as they have good reputations,¹⁷⁷ they are extremely reluctant to deal with someone who has been expelled from an association.¹⁷⁸ As one mill

174. ACSA BY-LAWS, *supra* note 72, at Art. 6, § 2.

175. SCA BY-LAWS, *supra* note 72, at Art. 6, § 1.

176. See Telephone Interview with Merchant #5 (no date) (noting that "being suspended has a tremendous impact on a trader's ability to do business. Mills do not want to take the added risk of non-delivery; no one would").

177. Some firms, however, steadfastly refuse to deal with nonmembers of any kind. Telephone Interview by Connie Rogers with MCE Merchant #9 (Aug. 13, 1997) ("We shy away from nonmembers of one of the associations or exchanges.").

178. Of thirteen mills surveyed, twelve said that they would be willing to deal with a nonmember of a shippers' association or exchange, one said he probably would not. Of those who would deal with a nonmember, three mentioned that they would want more information before doing so, and all but one said they cared about whether the merchants they dealt with were members of a shippers' association. In contrast, when asked whether they would deal with a merchant who had been expelled by a shippers' association, six mills said they would not, three said that they would be unlikely to, two said that it would depend on the reason for the expulsion, one did not answer the question, and one said that he certainly would not deal with someone who had been expelled from the Liverpool Cotton Association, but did not comment on domestic associations. The reputational harm of being expelled from a shippers' organization is augmented by the fact that most foreign buyers will not buy from a merchant who is not a member in good standing of the ACSA or one of its federated associations. As a consequence, a transactor who is expelled for a domestic default will also lose his international business. See, e.g., Letter from the ACSA Executive VP and Secretary to the WCSA Executive VP and Secretary (Jan. 5, 1981) ("[M]any importing countries look to the ACSA members for their supply of cotton . . . The ACSA sends a copy of its membership list and changes therein and its list of exporting members to domestic and foreign cotton organizations and this is constructive notice to these organizations of our current membership. A number of foreign countries require a certificate from some of our exporting firms that they are a member in good standing of the ACSA before they will be considered for tenders, sales of cotton, etc."). On occasion, however, a transactor will continue to deal with someone who has been suspended, if it is the only way he can expect to be paid. This is most common when the reason for the suspension is bankruptcy and the transactor thinks he will get more in a reorganization if he helps the debtor remain a going concern. See

explained, for a merchant, “be[ing] expelled [from a shippers’ association] is usually a death blow to [his] business.”¹⁷⁹ In addition, when a transactor is expelled from an association, he must forfeit his membership fee as well as other tangible benefits of association membership such as price sheets, technology circulars, and access to the group’s information services.¹⁸⁰

Although mill associations do not have similar membership rules and do not expel members who either refuse to arbitrate or default on arbitration awards, when mills contract under the SMRs and provide for BoA arbitration in their contracts, they also increase the reputational consequences attached to certain types of misbehavior. BoA opinions are circulated to all ACSA and ATMI members. Although the identities of the disputing parties are not revealed in the opinions, they often become known throughout the industry.¹⁸¹ These opinions

Telephone Interview with Merchant #1 (no date) (describing a situation in which, in an effort to obtain some payment, a large merchant continued dealing with a small merchant after he had been expelled for non-payment of an arbitration award).

179. Mill Survey, Respondent #1 (Aug. 11, 1997). One of the main differences between contemporary PLSs and the historical PLSs whose operations have been rigorously modeled by game theorists, *see supra* note 161, is that the antitrust laws prevent contemporary PLSs from adopting rules that punish transactors who deal with transactors who have themselves been expelled or suspended from the group for bad behavior. This limitation on secondary boycotts weakens the enforcement mechanism sustaining cooperation, but has two partially offsetting advantages. First, if secondary boycotts were available, the effective size of the sanction created by suspension or expulsion would increase and associations would likely limit the situations in which they could be imposed to those where the risk of erroneously imposing them is low, such as non-payment of an arbitral award. If the sanction remained available for all of the offenses that currently lead to its imposition, *see infra* note 183, it is likely that increased procedural safeguards would be demanded before it would be imposed. Adding these safeguards to the PLS, however, would likely erode some of its speed, cost, and secrecy-preserving benefits. In the absence of the secondary boycott, market transactors’ individual attitudes towards dealing with the individual in question determine the magnitude of the sanction, placing a check on the power of the arbitrators. If transactors think a decision was improper, they can continue to deal with the sanctioned transactor as before. Second, in contemporary commodities markets that move as fast as the cotton markets, if a transactor viewed himself as being at an absolute end-game stage relevant to the market as a whole forever, he would have an incentive to engage in extraordinarily risky behavior that might lead to widespread harm if it did not result in financial gains, behavior that he might not engage in if he thought that over time he could restore his good name and reenter the business.

180. The TCA, for example, restricts its information service to members. *See TCA BY-LAWS, supra* note 72, at Art. VII, § 9 (“All information so received by the Association . . . [under the rules relating to the information bureau] shall not be divulged or disseminated except to members. . . and shall be by them treated as confidential.”). Similarly, transactors who are expelled from the ACA must also forgo the use the association’s debt collection bureau. *See ACA BY-LAWS, supra* note 72, at Art. VI, § 1(a) (describing the operation and benefits of this bureau).

181. *See, e.g.*, Telephone Interview with Merchant #3 (no date) (noting that “sometimes [BoA] disputes stay quiet; some are well known”); Telephone Interview with Merchant #11 (2000) (same); Telephone Interview with Merchant #1 (no date) (explaining that at the MCE, “opinions may not be published or any information about the arbitration given out, yet it does become generally known”); *see also supra* note 172 (discussing how many MCE members learn about outcomes due to their roles in association affairs).

have the potential to damage a transactor's reputation. They often criticize the business practices of one or both of the disputants, and can be particularly harsh on a party who prevails on a technicality.¹⁸² They also commonly mention settlement offers, if any, and while these offers do not appear to influence the amount awarded, they may have strong reputation effects since they may signal to the market which transactor behaved more unreasonably and was responsible for the need for arbitration.

Thus, for these and other reasons, by joining an association and/or contracting under the Southern Mill Rules, a transactor greatly increases the value of the reputation bond he posts in each transaction.¹⁸³ This, in turn, reduces the likelihood that he will defect and more credibly signals to other industry members that he is a cooperative trading partner.¹⁸⁴

182. See *supra* notes 53-54 (providing examples of BoA decisions that criticize transactors' business conduct). Being mentioned in a negative light in an arbitration opinion is likely to cause more reputational harm than being mentioned in a negative light in a court opinion. Unlike court opinions which are written, if at all, five or six years after a dispute arises, making their reputation-related information of little predictive value, arbitration opinions are rendered very quickly, so any information they reveal will be viewed as current and relevant. In addition, arbitrators' opinions are more likely to cause reputational harm than court opinions, since they are written by highly respected industry members who understand the ins and outs of the business.

183. Joining an association further increases the value of the reputation bond a transactor posts in each transaction, since by becoming a member he exposes himself to the sanctions of suspension and expulsion with their attendant reputational and material consequences, for certain types of commercial behavior that are prohibited by the association By-Laws but not necessarily actionable in a claim for breach of contract. Most association by-laws prohibit certain types of "fraudulent trading practices" and other sorts of uncommercial conduct, and suspend or expel those who engage in them. Conduct for which these sanctions can be imposed includes "the adulteration or misrepresentation of the official USDA class in the form of green cards, computer printouts, or tag lists . . . [T]he shipment of Foreign Cotton against any contract specifying U.S. growth . . . [T]he shipment of reginned, blended or recleaned cotton which reginning, blending or recleaning shall have taken place after its original baling, unless specified and described as such in the contract," TRADING RULES OF THE WESTERN COTTON SHIPPERS ASSOCIATION § 2, R. 2 (1994) [hereinafter WCSA TR], as well as "conduct inconsistent with just and equitable principles of trade or of misconduct or of fraudulent breach of contract or of wilfully violating the Constitution, By-Laws or Rules of this Exchange." MCE CONST., Art. IX, § 1. When a complaint alleging fraudulent practices is filed, the board of directors holds a hearing. If two-thirds of the board members present find that the rules have been violated, the accused is suspended or expelled from the association. The accused then has a right to appeal in a hearing before the whole Association, but three-fourths of the votes cast are required for reversal. WCSA BY-LAWS, *supra* note 72, at Art. VI, § 1. Claims of fraudulent breach are infrequent, see, e.g., Telephone Interview with SCA and ACA Executive (Aug. 1996) (noting that over the past five years, only one person was expelled from the association for fraudulent breach of contract, when he shipped "gin motes" (trash) in place of bales), perhaps because they do not result in the aggrieved party obtaining a monetary recovery. Nevertheless, they may have a strong deterrent value because the penalty for violating them is high.

184. The reputation bond enhancing effects of exchange membership were even stronger in the past when social ties among members were even stronger and most business among members was done fact-to-face on an exchange floor. In those days, membership made even more aspects of a transactor's business behavior observable to other transactors, and the fact that members saw one another every day increased the speed with which gossip

The likelihood that cooperation will emerge in this market is further increased by the fact that most transactors view contracting relationships as long-term and indeterminate in length.¹⁸⁵ Many trading relationships span entire careers and transactors strongly prefer to deal with people they have done business with in the past.¹⁸⁶ In addition, because many firms are passed down from fathers to sons, fathers are unlikely to engage in end-of-career opportunism.¹⁸⁷ Even transactors who do not work in family-owned firms may consider the social and interpersonal costs of end-of-career opportunism to be prohibitively high. Retired merchants often seek honorary membership status in their associations so that they can remain involved in association-related business and social affairs.¹⁸⁸ Most spend a significant portion of each year in the small southern communities where they spent their working lives. Their wives are likely to be active in the industry's

was transmitted, thereby increasing the strength of reputation-based NLSs for misbehavior. See MACILWAINE, *supra* note 164, at 302 (“The hundred and seventy-five members of the Exchange see each other every day. About nine or ten o'clock in the morning they drop into the Exchange to get the quotations off the board and read the cables. The factors or sellers then go to their firms and the buyers make the rounds of the sample rooms. The pace is slow. Like Robert Frost's New England farmer they've got time to talk. During the off season, afternoon sessions of dominoes and checkers with occasional night sessions of poker and 'craps' weld the men into a sort of cotton fraternity. They have a common life of work and play — and also a common stock of traditional pranks like an initiation.”). In addition, in these earlier times, an expelled transactor would also lose access to information that at the time was too expensive for transactors to purchase individually, but today can be obtained cheaply, such as crop reports, weather forecasts, spot prices, and futures prices. See Interview by Mary LaBrec with MCE Executive (July 27, 1999) (explaining that in the early days of the industry, the cost of the information wire carrying quotations from New York and Liverpool alone necessitated a cooperative investment in an exchange).

185. Most formal, game theoretic explanations of the emergence of cooperation in repeat play contexts are based on the assumption (which, as the text indicates, holds in the cotton industry) that transactors view their contracting relationships as being indeterminate in length. See ERIC RASMUSEN, *GAMES AND INFORMATION* 121-23 (1989).

186. See Telephone Interview by Renée Liu with MCE Merchant #17 (Aug. 1997) (noting that his father dealt with a “certain handful of people . . . stayed with them. That's what's desired.” He [the son] would “shop” until he got the price he wanted, but “stick with the same people”); Telephone Interview by Renée Liu with MCE Merchant #12, buyer for mills (July 21, 1997) (stating that he dealt with “the same merchants all the time — approximately 26 or so”).

187. Conversely, a transactor's incentive to engage in opportunism when dealing with someone nearing retirement may be similarly constrained by a desire to retain the firm's business when it is passed down to the son. See, e.g., Telephone Interview by Renée Liu with MCE Merchant #17 (Aug. 1997) (explaining that he “deal[t] with people who [his] father dealt with,” people that he had “known for almost [his] entire life,” and that he knew who to do business with since he “paid attention” to who his father dealt with).

188. MACILWAINE, *supra* note 164, at 293 (noting that a merchant who had worked on Cotton Row for forty years explained “I wouldn't have been in any other business. I never cheated anybody in a deal, and most cotton men can say the same . . . It's interesting, fine business for any man. When I retired I was made an honorary life member of the Exchange. I'm proud of that, I can tell you”); see also SCA BY-LAWS, *supra* note 72, at Art.I, Sec. 1 (d) (creating the status “honorary member”).

women's groups¹⁸⁹ and may suffer social ostracism if their husbands behave dishonorably.

In sum, the industry has succeeded in creating a contracting framework that facilitates the emergence of cooperation in its shadow by "making the future more important relative to the present; changing the payoffs to the players of the four possible outcomes of a move; and teaching the players values, facts, and skills that will promote cooperation."¹⁹⁰

3. Maintaining Cooperation

In most contracting contexts, cooperation, once established, is vulnerable to breakdown. When the stability of cooperation is facilitated by transactors' decisions to follow a tit-for-tat type of strategy, there is always a risk that one transactor will misclassify an act of cooperation as an act of defection and thereby trigger a series of defections and counter-defections that might well lead to the unraveling of the contracting relationship.¹⁹¹ These misclassifications may be due to disagreement about the content of the governing trade rule or norm, disagreement about what actually took place (for example, whether the cotton shipped conformed to the contract specifications), or the difficulty of determining whether, if an undesirable outcome occurred, it was a mistake or an act of willful defection. Cotton industry institutions take a variety of actions that are designed to reduce the likelihood of these types of misclassifications and thereby increase the likelihood that cooperative contracting relationships, once established, will endure.

First, the industry devotes significant resources to activities that reduce the likelihood that transactors will disagree about what types of behavior are to be classified as cooperation and what types are to be classified as defection. Associations go to great lengths to draft clear trade rules and to ensure that industry members know and un-

189. See *supra* note 118 (discussing the Cotton Wives Clubs). More recently, the Cotton Wives have reconstituted themselves into state and regional associations of "Cotton Women." Although the stated purpose of these groups is to assist the National Cotton Council with its "Grown and Made in the USA" consumer awareness campaign, they have continued many of the Cotton Wives' Clubs more traditional activities. Recently, the Cotton Women's Committee co-sponsored the first ever U.S. Cotton Champion Award, an updated replacement for the old Maid of Cotton Pageant. See *Texas Firm Receives Cotton Champion Award*, COTTON DIGEST INT'L (Feb. 2000), available at http://www.utexas.edu/depts/bbr/natfiber/natnews/2000/Apr.2000.nat.htm#TEXAS_FIRM_RECEIVES_COTTON_CHAMPION_AWARD.

190. ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* 126 (1984).

191. See, e.g., AVINASH K. DIXIT & BARRY NALEBUFF, *THINKING STRATEGICALLY: THE COMPETITIVE EDGE IN BUSINESS, POLITICS, AND EVERYDAY LIFE* 106-15 (1991) (explaining why a pure tit-for-tat strategy is so vulnerable to cooperative breakdown and suggesting some ways that it can be modified to make cooperation more likely to endure).

derstand them. Association circulars and reports commonly include discussions aimed at clarifying the meaning of rules.¹⁹² Rule changes are announced at annual meetings, publicized through association circulars,¹⁹³ and are sometimes discussed in the trade press.¹⁹⁴ New merchants are strongly encouraged to attend the eight-week summer Cotton Institute that includes courses on the content of the most important sets of trading rules. The associations also urge their mem-

192. See, e.g., Report of the Committee on Rules, By-Laws and Fair Practices, Adopted at the 43rd Annual Convention of the ACSA, San Francisco (1967) ("Your Committee wishes to acquaint the membership with the 'INTERPRETATION OF RULE 9 OF THE ASSOCIATION'S SPECIAL RULES' passed this year by the Board of Directors, a copy of which is attached hereto."); Minutes of the ACSA-ATMI Joint Meeting (1951) (where, in response to a complaint by the mill representatives of trouble caused by the use of cement sacks, camouflage cloth, and similar materials for bale coverings, the meeting unanimously resolved that ACSA "circularize its members and [other cotton groups] . . . calling attention to Southern Mill Rule 37-A and to the fact that the Cotton Committee of the American Cotton Manufacturers Institute, Inc., according to its interpretation, states that Rule 37-A is being violated; that cement sacks, camouflage cloth, etc., do not come within the provisions of this Rule; and that no cotton bagging does come within the provisions of the Rule except that specified in U.S. Government Specification . . . that further no allowances would be paid except for bagging meeting this government specification"); Minutes of the ACSA-ATMI Joint Meeting (1974) (where ACSA agreed to circularize its members to "draw[] attention to responsibility of the respective parties on all 'on-call' sales"); Minutes of the ACSA-ATMI Joint Meeting (1969) (noting that both ACSA and ATMI agreed to circularize their membership to remind them of the requirements of CSAB Rule 14 concerning size and representative quality of samples for arbitration). In addition, from time to time the rules are republished and sent to the memberships of both ACSA and ATMI. In the past, strips of paper that could be pasted into old rulebooks over revised rules were mailed to members between reprintings of the rules.

The MCE also has a Committee on Trade, which has the duty "to consider, and from time to time report, such rules and regulations regarding the purchase, sale, transfer, etc., of cotton, as will be convenient to all parties concerned, and thereby facilitate and increase business." MCE BY-LAWS, *supra* note 10, at Art. IX, § 1. Circulars are sent out to the membership to acquaint them with amendments passed by the Board of Directors. See, e.g., *To the Members*, MCE Circular, Dec. 17, 1951 (reporting the rewrite of a rule, its effective date, and the rationale for the change).

193. See, e.g., Minutes of the ACSA-ATMI Joint Meeting (1970) (noting that both associations committed themselves to circularizing their memberships about the changes in Rule 23 and Rule 26); *Letter to All Members*, ACSA Series A-Circular Letter No. 43 (Dec. 21, 1970) ("Six changes in the Southern Mill Rules were approved . . . Please place these [copies of the new rules] in your copy of the rule book for ready reference."); *Letter to All Members*, ACSA Series A-Circular Letter, No. 5 (June 18, 1969) (reporting that at the 45th Annual Convention, Rule 5 and Rule 6 were amended and the following new Rule 11 was added: "RULE 11: THE SPECIAL RULES WILL APPLY ONLY WHERE A U.S. GROWTH IS SPECIFIED IN THE SALES CONTRACT. THE SPECIAL RULES WILL NOT APPLY WITH RESPECT TO YEAR OF GROWTH"). The associations also undertake systematic efforts to inform members about rules changes. After each ACSA-ATMI Joint Meeting on the SMRs, a report is distributed to the members of both associations.

194. See, e.g., *Cotton Traders To Change Rules*, COM. APPEAL, June 9, 1992, at B5 (reporting that "[c]otton trading rules that apply to members of the Memphis Cotton Exchange will change from Rule 3 to Rule 5 Under Rule 3 . . . cotton merchants or brokers pay warehousing costs. . . . Rule 5 . . . shifts those costs to cotton growers"); *Exchange to Keep Cotton Sales Rule*, COM. APPEAL, Sept. 26, 1991, at B8 (noting that unlike the MCE, the Greenwood Exchange had no plans to change its trading rules); Charles Conner, *Agricultural Briefs*, COM. APPEAL, Mar. 8, 1992, at C4 (discussing the change from Rule 3 to Rule 5 trading and changes in the "Rule 19 penalty for light-weight bales").

bers to come to informal understandings on subjects not dealt with explicitly by the rules,¹⁹⁵ and sometimes encourage firms to educate their employees about certain aspects of the rules.¹⁹⁶ In addition, the BoA's practice of circulating its arbitration opinions, which often contain preachy statements about what is and is not acceptable business behavior,¹⁹⁷ and the many ACSA and ATMI circulars that try to use moral suasion to induce transactors to adopt particular practices not required by the rules,¹⁹⁸ further contribute to the creation of a rough consensus as to the contours of acceptable behavior.

Second, the industry has created a separate tribunal, the CSAB, to deal with the most common type of fact-based misunderstanding, namely disagreements over whether a delivery conforms to the contract's quality specifications. Quality is an aspect of performance that, in the absence of the CSAB, might lead to the breakdown of many relationships. Even in the absence of opportunism, two cotton transactors, each acting in good faith, might well disagree about how to grade a particular shipment, and each might therefore conclude that the

195. The WCSA Rules, for example, contain a nonbinding note that follows the rules dealing with the quality of tender. The note states that "[b]uyers and sellers should be careful to agree among themselves as to the tolerances of qualities deliverable under the contract, when the quality is guaranteed through as stated. While it is almost impossible to preclude variances of qualities in a shipment from the quality stated, sellers should be cognizant of buyers' expectations in this regard, and in keeping with fair and reasonable practices of the trade, should disclose to buyer any severe variance in quality of the intended shipment." WCSA TR, *supra* note 183, at § II, R. 1, cl. 1.

196. See, e.g., *Letter to All Members*, ACSA Series A-Circular Letter, No. 5 (June 18, 1969), circulated with a copy of the amended rules ("We wish to call forcefully to the attention of the membership the practices which are listed in the Special Rules and to advise that principals of firms review these rules with their employees.").

197. See *supra* note 54.

198. ATMI and ACSA have each gone to great lengths to persuade the other organization to circularize its members asking (but not requiring) them to act in particular ways or to comply with particular rules. This suggests that each believes that these nonbinding recommendations have enough force to add at least some value to transactions. See, e.g., Minutes of the ACSA-ATMI Joint Meeting (1981) (where the ATMI expressed its reluctance to approve any changes to Rules #22, 46 or 47, but pledged instead to "attempt to influence all mills to live up to [Rule #22] as written," by publicizing the rule in "Textile Trends," [an association sponsored publication] and indicated that it was also willing to consider a special mailing "on the matter" from the Chairman to mill principals); Minutes of the ACSA-ATMI Joint Meeting (1976) (where ACSA "requested cooperation again from the ATMI in urging their members to receive cotton five days a week, thus utilizing to a greater degree our transportation facilities," and the mill representatives responded that they would be glad to recircularize this message); Minutes of the ACSA-ATMI Joint Meeting (1974) (where ACSA "again requested that the ATMI circulate a memorandum to its members pointing out the problems incurred by some shippers by failure of the mill to properly care for rejections," and ATMI responded that it would be "happy to do this again, as it was definitely the responsibility of the mills to properly care for rejections"); Minutes of the ACSA-ATMI Joint Meeting (1973) (where ATMI agreed to circularize its membership about returning rejected bales to the shippers in the same condition in which they had arrived); Minutes of the ACSA-ATMI Joint Meeting (1966) (where ATMI and ACSA failed to agree on a rule dealing with Friday delivery, but the ATMI agreed to try to enlist "the cooperation of everyone" by circularizing its own membership on the subject).

other has defected. The ability to submit the goods to a neutral tribunal at a low cost and to obtain a quick ruling on the subject without filing a claim for breach can play an important role in preventing contractual relationships from unraveling.¹⁹⁹ To understand why, suppose that a seller (*S*) ships what she thinks are conforming goods to a buyer (*B*) who claims that the goods arrived in a nonconforming state. If *B* calls *S* and says the goods are nonconforming, *S* will have no way of knowing if this is true. Although she knows that she shipped conforming goods, there is always the unavoidable and not insubstantial risk that they were damaged in transit, which makes it difficult for her to tell whether *B*, by complaining, is cooperating or defecting. In such a situation, *S* can request that the cotton be sent to the CSAB. If the arbitrator says the goods are nonconforming, *S* will realize that she in fact defected. She might then offer to cure, an option given to her as of right under the trade rules,²⁰⁰ or she might attempt to reach a price adjustment with *B* (most likely, one at least slightly favorable to him). However, even if these attempts fail and *B* responds with defection, *S* will conclude that *B*'s defection is merely in response to her own defection, and that if she decides to respond with cooperation, *B* may do the same, thereby preventing the breakdown of the relationship.²⁰¹ In general, transactors do not view asking for quality arbitration as damaging to their commercial relationship as long as it is not done too often. It is widely recognized that two cotton men acting in good faith may well grade a particular lot of cotton differently.²⁰²

199. The importance of resolving this type of disagreement quickly is reflected in the MCE trading rules. See MCE TR, *supra* note 17, at R. 34, cl. 2 ("In any case relating to the classification and delivery of cotton where it is shown that an immediate decision is desirable, the President . . . may . . . appoint a special committee of three members with full power to waive all bond and formalities and render an immediate decision."). In addition, in merchant-to-mill transactions, the availability of CSAB arbitration creates an incentive for merchants not to make opportunistic use of the cure provision in the SMRs. When the CSAB determines goods to be nonconforming, gossip based on this verified fact can be at least mildly damaging, thereby increasing the cost of cure to the breaching party and giving him an increased incentive to avoid intentionally sending nonconforming goods in the first place.

200. SMRs, *supra* note 5, at Art. III, § 9 ("All cotton rejected by buyer against contract must be replaced by delivery of an equal quantity as the cotton rejected, and of the quality of cotton specified in the contract, within fourteen business days of mutual agreement regarding rejections, or of final decision by arbitration as herein provided for.").

201. For a more technical discussion of this type of strategy, known as "contribute tit-for-tat," see ROBERT AXELROD, THE COMPLEXITY OF COOPERATION: AGENT-BASED MODELS OF COMPETITION AND COLLABORATION 34 (1987) (noting that a contribute tit-for-tat strategy is one that "has three states: 'contribute,' 'content' and 'provoked.' It [the strategy] begins in content with cooperation and stays there unless there is a unilateral defection. If it was the victim while content, it becomes provoked and defects until a cooperation from the other player causes it to become content. If it was the defector while content, it becomes contribute and cooperates. When contribute, it becomes content only after it has successfully cooperated").

202. Telephone Interview with WCSA Executive (July 1996) (opining that most traders view quality disputes as just a routine part of doing business).

Although the quality intermediary can determine whether a shipment conformed to the contract, it does not reveal any information about whether the seller intentionally or mistakenly shipped nonconforming goods or whether the buyer genuinely thought the goods were nonconforming or attempted to reject them for opportunistic reasons. Despite the fact that the industry has taken numerous steps to reduce misclassification risk by promoting widespread agreement on the meaning of rules, the vagaries of weather and agriculture, as well as the complexities of cotton storage and transportation, nevertheless result in many situations in which it is difficult if not impossible for the promisee to determine whether an undesirable outcome reflects an act of defection, or simply bad luck. Across the market, the risk of inadvertent breach, even after optimal precautions have been taken, is high. In such situations, cooperation is more likely to be maintained if transactors do not respond to every bad outcome by inflicting a punishment. Transactors might, for example, adopt a strategy of attempting to negotiate adjustments in such situations, either until a particularly severe bad outcome occurs, or until a pattern of frequent bad outcomes leads a transactor to conclude that he is dealing with a defector and should therefore terminate the relationship. Alternatively, transactors might adopt a strategy that punishes the defector for a limited number of transactions or until he starts cooperating again.²⁰³ Such strategies are commonly followed in the cotton market.²⁰⁴

Negotiating forgiving adjustments until the relationship is terminated is common in transactions between mills and merchants.²⁰⁵ Transactors typically adjust or attempt to adjust their obligations several times before initiating an arbitration,²⁰⁶ an action that sometimes,

203. See DIXIT & NALEBUFF, *supra* note 191 (discussing the conditions under which modified tit-for-tat strategies are desirable); AXELROD, *supra* note 201, at 34 (explaining that in a repeat play prisoner's dilemma in a noisy environment, reciprocal strategies can be improved upon by incorporating "generosity," that is, by "allowing some percentage of the other player's defections to go unpunished").

204. The "tat" move dictated by these more forgiving strategies — typically either refusing to deal for a specified period of time, or terminating the relationship after a series of defections — is a form of bilateral NLS that is unlikely to be imposed in an opportunistic manner. Because the execution cost savings of a repeat-dealing relationship accrue to both transactors, neither has an incentive to suspend or terminate the relationship unless the other has done something that suggests that he will behave poorly in the future. Thus, while these sanctions can lead to deadweight losses when they are mistakenly imposed (an action more forgiving versions of tit-for-tat strategies are designed to reduce), they are unlikely to be opportunistically imposed.

205. See, e.g., Record, BoA Case No. 136 (1995) (revealing that the seller modified the payment schedule numerous times and that the buyer consistently failed to meet the modified schedule, leading the seller to file a claim in arbitration); Record, BoA Case No. 121 (1985) (where the buyer gave the seller many extensions on delivery before filing for arbitration).

206. When mill representatives were asked what they did when a dispute arose, most stated that they would try to work it out with the merchant, see, e.g., Mill Survey, Respondent #5 (Aug. 8, 1997) ("Work out with merchant."); Mill Survey, Respondent #4 (Aug. 6,

but not always, ends their contracting relationship.²⁰⁷ Members of the MCE commonly ignore defections or make forgiving adjustments in response to a certain number of defections, and then respond to defections thereafter with punishment of a limited variety, such as going to arbitration to obtain a monetary recovery,²⁰⁸ perhaps refusing to deal for a specified period, or spreading a little negative gossip,²⁰⁹ and then returning to cooperation. Similar responses to defections have also been adopted by some mills.²¹⁰

The cost of adopting relatively forgiving strategies is lower in the cotton industry's PLS than it is in the public legal system. In the public legal system, the Code's course of performance and course of dealing provisions increase the cost of agreeing to forgiving adjustments. They

1997) (“[T]ry an amicable settlement; go to arbitration when all else fails.”); Mill Survey, Respondent #3 (July 28, 1997) (“[T]ry to work it out.”); Mill Survey, Respondent #7 (July 31, 1997) (“We try to work things out between ourselves. If not we will go to arbitration.”); Anonymous Mill Survey (July 31, 1997) (“Contact individual in which [sic] agreement was made and discuss all facts pertaining to the dispute and try to seek a reasonable agreement for both parties. To take a merchant to arbitration would be the result of absolute disregard of a contract or verbal agreement. Circumstances requiring arbitration would be for extremely poor performance, non-delivery of cotton and failure to make compensation.”).

207. A significant percentage of the disputes reaching the BoA appear to be absolute end-game disputes, that is, disputes where the parties do not intend to deal with one another in the future. Between 1975 and 1996, for example, 54% of the cases heard by the BoA, were clearly absolute end-game disputes. Most commonly, the event triggering the end-game was the insolvency or financial distress of a party, the closing of a cotton office, a change of control of one of the entities involved, or the retirement of a person directly involved in the transaction, all events that upset settled expectations. Another 18% of the cases involved disputes that might fairly be classified as end-game. They involved disputes over the effects of a government subsidy program that made large sums turn on who had possession of cotton on a particular day. These cases were ones in which an event took the contract out of the self-enforcing range and made it worthwhile for one of the parties to end the contracting relationship. The remaining 27% of the cases involved primarily factual disputes about late payment and late delivery.

208. A look at the opinions, written evidence, and moving papers (but not necessarily the transcripts which were mostly unavailable), in all MCE cases from 1944-1990 provides evidence that transactors routinely make forgiving adjustments — they accept late payment or late delivery, extend the time for payment or delivery, cancel deals, or accept substitute goods — and that the filing of a claim in arbitration is often preceded by several such adjustments. *See also* sources cited *supra* note 205.

209. *See, e.g.*, Telephone Interview by Connie Rogers with MCE Merchant #9 (Aug. 13, 1997) (noting that in “a friendly arbitration, [with] both sides a little wrong and a little right, the animosity may wear off after a few months and they’ll probably deal with each other again”); Letter from Defendant, to MCE Executive Vice-President and Secretary (Mar. 15, 1976), in connection with MCE Case No. 828 (“[The plaintiff] and I have been friends a long time and regardless of the outcome we expect to remain such.”).

210. For example, in response to the question, “If you go to arbitration against a merchant and he complies with the award, will you do business with him in the future? If so, would you do so immediately?”, one mill answered, “should we go to arbitration and it was settled and the award complied with we would likely do business again — probably we would wait one or two seasons,” Mill Survey, Respondent #5 (Aug. 8, 1997); another said, “yes . . . would wait a year or two,” Mill Survey, Respondent #7 (July 31, 1997); and another said, “I would carefully weigh the situation and depending on the seriousness determine the time factor for relations to be re-established.” Anonymous Mill Survey (July 31, 1997).

create a significant risk that a series of such adjustments will be found to constitute a course of performance or course of dealing that will operate as a waiver or modification of the terms of transactors' written contracts and will therefore limit the ability of the breached-against party to impose formal sanctions in the future for breach of the contract's explicit terms if the breaches turn out to have been a series of willful defections.²¹¹ In contrast, the refusal of cotton tribunals to permit course of dealing or course of performance to vary or modify contractual provisions eliminates the risk that forgiving adjustments will be interpreted as waivers or contractual modifications.²¹² It therefore increases the likelihood that transactors will find it worthwhile to behave flexibly and encourages them to adopt the types of forgiving strategies that are most likely to promote commercial cooperation.²¹³

There is an additional efficiency benefit to using a forgiving version of the tit-for-tat strategy, particularly when the "tat" punishment is costly for the defected-against transactor to impose. The most com-

211. The fact that transactors are aware of this approach and can therefore adjust their reliance on extralegal understandings in accordance with their view of their likelihood that they will be voluntarily performed, together with the short statute of limitations at the MCE and the other deadlines for objections written into the rules, help to mitigate the likelihood of the types of opportunism that such an adjudicative approach might lead to. For example, a buyer who always takes late delivery under a contract then suddenly wants to end the relationship and tries to sue for past deviations will not be able to go very far back in time if he chooses to do so.

212. The BoA has also consistently refused to uphold oral modifications of written contracts. See SEAB Case No. 80 (1957) (where the seller claimed that Buyer's employee said that Seller "could take all the time needed to make delivery;" the Board held that "this does not enter into this case since the contracts specify a definite delivery date, and if there had been any different agreements they should have been embodied in the contracts"); SEAB Case No. 66 (1953) ("The Appeal Board is interested only in the contract or in written statements affecting the conditions of said contract. We do not find any changes agreed to in writing altering the original contract."); SEAB Case No. 56 (1950) (noting the seller's contention that an employee of the buyer orally agreed to a modification of the contract, the arbitrators held that "[i]t is our opinion that the terms of the contract stand for themselves and the conditions set forth therein are the only conditions which would pertain to the fulfillment of the contract"). In addition, the BoA does not look to evidence from precontractual negotiations to determine the scope of the parties' agreement. See NEBoA Case No. 318 (1940) ("The Board . . . finds the parties both bound by the terms of the signed purchase orders and that prior negotiations are not entitled to consideration as the terms of the purchase orders with respect to grade and staple are not ambiguous."). The MCE arbitrators take a similar approach. See MCE Case No. 789 (1952) (concluding "[t]hat while the trade was originally [orally] made under Rule 7 of the Exchange Trading Rules, which rule provides that payment shall be made free of Exchange in Memphis funds or the equivalent, and that exchange to final destination shall be deducted from the invoice, due to the fact that seller's written confirmation made a change in the exchange provision and as buyer made no objection to the change outlined in said written confirmation, the written confirmation became a mutually agreeable contract and buyer is bound by its terms"). These aspects of the tribunals' adjudicative approaches increase transactors' confidence that extralegal aspects of their behavior and communications will not be transformed into legally enforceable commitments.

213. For a more detailed discussion of how formalistic adjudication can support flexible contractual relations in its shadow, see Bernstein, *Merchant Law*, *supra* note 60.

mon “tat” moves in cotton transactions — some combination of terminating the contracting relationship, seeking arbitration, and/or imposing a reputation-based NLS like widespread negative gossip — are often costly to the person imposing them.²¹⁴ In such situations, more deterrence can be obtained by imposing a larger sanction less frequently than by imposing smaller sanctions more frequently. When negative gossip is based on one transaction going poorly, others might dismiss it, since it is difficult for them to be sure that it was not either an inadvertent breach after sufficient precaution or a breach due to simple bad luck. Even if the sanction is imposed several times in sequence, it will be less effective and more costly than a larger sanction imposed after several defections. Consider, for example, three instances of negative gossip, each of which, if imposed in isolation, would impose $\$X$ in reputational harm. If such gossip sanctions were imposed three times in close proximity to one another, the harm to the defecting transactor’s reputation would be more than $\$3X$ because each instance of gossip gains credibility from the one subsequent to it. However, when NLSs are imposed seriatim, the cost of imposing them has to be borne three times, and as more time passes between incidents, the cumulative impact of the sanctions will decline — transactors are more likely to forget previous incidents if they seemed minor at the time — and, since the flow of gossip is hard to predict, it is not clear that the same people will necessarily hear about all three incidents, thus decreasing the impact and increasing the cost of imposing the sanction. In contrast, when the gossip is based on several incidents, both the person contemplating imposing the sanction and the others who are told of the wrong doing, will be more confident that the breaching party is a defector deserving of a “tat” response.²¹⁵ In such a

214. Spreading negative gossip takes time and a transactor must be judicious in deciding whether to do it. A transactor who spreads negative gossip too often, or is too harsh in his judgements, risks being viewed as being difficult to work with. In addition, there is a strong norm against baseless gossip. A transactor who is found to have fabricated gossip will suffer tremendous reputational harm. In addition, the availability of low cost access to the PLS puts a soft check on the extent to which baseless gossip can damage a transactor’s reputation. At a certain point, the victim of the gossip can defend himself by asking why, if he acted so badly, the gossiper did not take him to arbitration. As one merchant explained when asked why people bother to gossip about wrongdoers, “no one wants to see the industry hurt by an unscrupulous person.” Telephone Interview with Merchant #11 (no date). Others explained that it was an industry where emotions ran high and notions of honor and avenging honor motivated behavior.

215. Another advantage of this approach is that it will often result in willful breaches being punished more severely than inadvertent breaches. In contexts like cotton transactions, where the risk of inadvertent breach even after optimal precautions have been taken is high, and where absent successful renegotiation, transactors want performance, not payment for nonperformance, *see supra* notes 135-137 and accompanying text, they might find it desirable to impose high monetary sanctions for willful breach and moderate sanctions for inadvertent breach — in an effort to encourage performance without encouraging overinvestment in precautions against breach. However, a legal system (whether private or public) that imposed different monetary sanctions on willful and inadvertent breach would face formidable barriers to implementing such an approach. First, in any one case, the willfulness

situation, the accuracy of the decision to impose the sanction is improved, and the magnitude of the sanction that can be imposed also increases since negative gossip will be more credible and transactors will give it more weight in deciding whether or not to deal with the defecting party. Thus, when transactors decide to follow a forgiving version of tit-for-tat they can obtain more efficient deterrence.

More generally, recognizing the importance of reducing the likelihood of misunderstanding in any relationships in which valuable cooperation is sustained through both transactors following a variant of the tit-for-tat strategy suggests that in deciding which provision to include in a contract or what type of extralegal understandings to reach, the transactors must assess the "misclassification risk" of the provision or understanding. As their relationship develops, execution costs will

or nonwillfulness of a breach may not be verifiable by a tribunal, or even observable to the parties. Nevertheless, over a period of time and a series of breaches, the willfulness or inadvertence of his transactional partner's actions may become clearer to an aggrieved party. As a consequence, given the inability of a judge or arbitration panel to distinguish between willful and inadvertent breach in a particular case, the higher measure of damages would, in practice, have to be available for all breaches. Such an increase in the damage measure, however, would likely lead to an over-investment in precautions against inadvertent breach. Second, given that the industry has adopted something akin to the perfect tender rule with cure (albeit within the industry's designated allowances on a variety of quality dimensions) buyers can nonetheless usually find a way to claim breach under the rules. As a consequence, if very large monetary damages were available in arbitration, buyers might have an incentive to declare breach in many situations where they would otherwise simply have accepted the goods. In contrast, where hybrid monetary and NLSs are used to sanction willful breach, a lower level of monetary sanctions can be combined with a NLS imposed only after the willfulness or nonwillfulness of breach becomes clear, thereby decoupling the amount "paid" by the breaching party (the monetary damages ordered by the arbitrator plus the NLS imposed by the aggrieved party), from the amount "received" by the aggrieved party (the monetary recovery plus any small deterrence advantage of imposing the NLS, less any cost of imposing the NLS, *see infra* notes 227-229 and accompanying text), which in turn eliminates (or at a minimum greatly reduces) the aggrieved party's incentive to declare breach when there is a minor nonconformity in tender simply to get the larger monetary recovery.

There is a great deal of evidence that extent of gossip (and hence the magnitude of the NLS imposed) is highly dependent on transactors' perceptions of the willfulness or nonwillfulness of the behavior at issue. *See* MCE Merchant Survey, Respondent #4 (May 30, 1997) (When asked whether and under what conditions he would spread negative gossip, a merchant replied, "sometimes yes: when defendant refused to honor I'd publicize that fact. Sometimes no: when an honest mistake was made, I wouldn't talk"); MCE Merchant Survey, Respondent #3 (May 27, 1997) (noting that he had been involved in two arbitrations. "One case involved a party who did not deliver in a timely manner," but because the breaching party "did not understand the importance, [he] would probably deal with him again in time," and he did not gossip after the arbitration. In contrast, the second case dealt with "a party who was looking for any loop-hole to avoid a financial loss." In this instance, he did talk about the case. He explained that, "in the case of willful non-fulfillment . . . [I talked] as [I] did not want this party to continue his poor practices"). Moreover, this system of decoupled hybrid sanctions is particularly well suited to ferreting out opportunistic transactors and transactors who act in what one industry executive called "the arbitrage way," rather than the "gentlemen's way." Telephone Interview with ACSA Executive (no date). It confronts such a person with escalating sanctions, both because each instance of gossip gains credibility from the one after it (especially if it is from a different person), and because as a person gradually acquires a bad reputation, transactors are likely to watch the person more carefully, thereby detecting more instances of wrongdoing.

decrease and switching costs will increase, making the misclassification risk an increasingly important feature of their contracting relationship. This, in turn, may lead them to adopt contract provisions that in the absence of a need to maintain cooperation would not be chosen. Alternatively, either because at the outset of a contracting relationship transactors may not know whether their relationship will be discrete or repeat, or because a company enters into hundreds of contracts a day and therefore finds it cheaper always to do business using a single standard form,²¹⁶ recognizing the importance of misclassification risk might not necessarily lead to the use of different contract terms. Transactors may prefer instead to vary or supplement some of their contracts' written provisions through extralegal understandings (made credible through NLSs) that can reduce misclassification risk, perhaps because they condition on information that is more cheaply observable to the transactors at the relevant time. By using written contracts and varying them through extralegal understandings that may be better tailored to the needs of work-a-day interactions, transactors may be able to capture execution cost savings and reduce the likelihood of relationship breakdown (for this reason, these understandings are sometimes referred to as relationship-preserving norms) while at the same time retaining their right to insist on strict adherence to the terms of their written contracts if their relationship breaks down.²¹⁷

216. The best verifiable term for a contract may be quite similar across relationships since the factors that determine verifiability are unlikely to be vastly different in different transactions. In contrast, what is observable, varies a great deal from relationship to relationship and even varies over time within a given relationship. As a consequence, transactors may always find it desirable to use the same or substantially the same written provisions while varying their extralegal understandings depending on who they are dealing with and the stage of their contracting relationship.

217. It is important to note that even in selecting the terms conditioning on verifiable information that they view as most desirable in the event that a dispute requiring third-party adjudication arises (a so-called end-game situation of one sort or another, *see* Bernstein, *Merchant Law*, *supra* note 60), transactors may, in some instances, be influenced, at least in part, by their desire to provide the most desirable terms for the relationship-preserving phase of their interactions as well. To see why, consider transactors' choice between two provisions: provision *A*, that conditions on information that is verifiable but not observable, and provision *B*, that conditions on information that is both verifiable and observable. Further assume that the cost of verifying the information under provision *B* is greater than the cost of verifying the necessary information under provision *A*. If only the end-game were to be considered, provision *A* would be better (assuming that in end-game the two provisions had the same payoff if performed, and would give rise to the same damages if breached) since the information it conditions on can be obtained at a lower cost. However, in their every-day-repeat dealings, provision *A* would present difficulties. Because transactors would have difficulty figuring out whether the provision had been satisfied (something that by definition would not be observable to them), its use might therefore increase the likelihood that an instance of performance would be misclassified as an instance of breach and lead to the breakdown of the relationship. As a consequence, while provision *A* would be cheaper to invoke if a dispute arose, the probability of a dispute arising would be higher. In contrast, while the cost of adjudication if a dispute arose is higher under provision *B*, the risk of breakdown would be much lower since the information provision *B* conditions on is observable to the transactors. Taking the risk of breakdown and the benefits of avoiding it into account, the transactors might prefer to include provision *B* in the contract.

Using this two-tiered structure enables transactors to write a contract with the provisions best suited to third-party enforcement while varying these provisions using relationship-preserving norms that are well suited to reduce misclassification risk and promote cooperation. There is suggestive evidence that cotton transactors may view themselves as conducting their everyday interactions according to a set of flexible understandings that requires them to make many adjustments, and ignore minor deviations in ways not required by their contract's written provisions, yet preserves their unfettered right to insist on strict performance of their contract when they think their contracting partner is behaving badly. As one mill executive explained, "SMR is [sic] used as an outline only in most cases. . . but if disputes arise — both parties fall back on SMR [sic] to resolve" them.²¹⁸ And, as another explained, when asked whether everyday practices varied from the SMRs, "yes, I would say many, especially related to late delivery, late payments, notification of claims, etc. Most mills and merchants work with each other and have informal unwritten understandings to a limit. If it became apparent to me that a merchant had bad intentions, I would immediately invoke SMR rights."²¹⁹

Once transactors have established a contracting relationship, they will often structure their contracting relationships in a way that further increases the costs each will suffer if either defects, thereby making cooperation the preferred choice. Most merchants and mills, rather than entering into one large long-term contract with numerous installment deliveries, instead enter into multiple contracts with overlapping performance times.²²⁰ For example, on January 1, they might enter into a contract for delivery on February 1; on January 15 they might enter into a contract for delivery on February 15th and another for delivery on March 1, and so on. Each time the transactors enter into an additional contract to be performed in the future, they increase the cost to both of them of either of them misbehaving today. If one transactor defects and the other responds by defecting, relations between them will quickly deteriorate. In the subsequent contracts, each transactor is likely to demand exact compliance with the contract,

218. Mill Survey, Respondent #1 (Aug. 11, 1997).

219. Mill Survey, Respondent #5 (Aug. 8, 1997); ; *see also* Telephone Interview by Renée Liu with Mill #12 (Oct. 7, 1997) (noting that there are differences between everyday practices and the SMRs in that "payments are looked at loosely . . . fixation term is obsolete . . . time deadlines [are] often winked at . . . wouldn't buy in cotton sometimes [even if delivery is late] if we didn't need it badly . . . [we] dance around that"); Telephone Interview by Renée Liu with Mill #13 (Oct. 8, 1997) (noting that the biggest variation from the rules relates to payments); Mill Survey, Respondent #5 (Aug. 8, 1997) (explaining that these differences relate to "late delivery, late payment, notification of claims"); Mill Survey, Respondent #6 (July 30, 1997) (noting that most divergences between SMRs and practice "have evolved through the continued partnership of vendor — customer").

220. *See, e.g.*, Record, BoA Case No. 139 (1976) (illustrating the existence of multiple separate and overlapping contracts between the parties).

thereby greatly increasing execution costs and requiring both transactors to forgo all of the value created by their extralegal agreements. By putting these future gains at risk in each transaction, the transactors create what has been called “private enforcement capital.”²²¹ In effect, they create an implicit performance bond (whose magnitude is further increased by reputation-based NLSs) that they will sacrifice in the event of breach. They thereby increase the likelihood of cooperation by increasing the cost of defection.

Cotton trade associations also take numerous other steps to increase the likelihood that cooperation will endure and that the residual opportunities for opportunism will be minimized²²² — including promoting altruism, encouraging people to incorporate the welfare of the group (or others) into their utility function,²²³ creating social connections between members and their families, and explicitly teaching transactors about the importance of reciprocity and commercial reputation.²²⁴ These efforts, many of which are undertaken at the association level, provide benefits for all group members. The more widely norms of reciprocity are diffused throughout the relevant population, the better will be the ability of the group to “police the entire community by punishing those who try to be exploitative,” which in turn “decreases the number of uncooperative individuals [any one trader] will have to deal with in the future,”²²⁵ thereby lowering the transactions costs of trade.

221. See generally Klein, *supra* note 152 (exploring the creation and use of private enforcement capital).

222. See AXELROD, *EVOLUTION*, *supra* note 190 (discussing steps that increase the stability of cooperation).

223. Cotton industry institutions go to great lengths to instill a sense of solidarity or joint purpose in their members. See, e.g., Dr. Orley B. Caudill, Interviewer, An Oral History with Mr. W.D. Lawson, III, Mississippi Oral History Program of the University of Southern Mississippi, Vol. 126 at 15 (1980) (“We would have meetings as merchants, in fact we think we were better organized than any group there because we even had meetings before meetings. We were in constant communication with one another. Being a smaller group, we could do this and we spoke with one voice.”). To encourage international solidarity, cotton firms around the world have long educated each other’s apprentices or “squidges.” See BUSH, *supra* note 113, at 13 (relating that “[a]mong the firm’s half-dozen samplers and sample-room porters, there’s nearly always one foreign squidge; this is a time-honored practice in all cotton houses and has made the cotton world a club. Family connection often plays a part”).

224. The industry sponsors a college for new members that encourages young traders to inquire closely into the reputations of their trading partners. See Neal P. Gillen, Resolution of Contract Disputes in the Commerce of Cotton Within and Without the U.S., Lecture at Rhodes College (July 20, 1995) (transcript on file with author) (“I urge each of you to deal only with those who you know and trust. If you do not know the producer, the ginner, merchant, or textile mill, check them out thoroughly. If the price or terms are too good to be true, they usually are. This is a competitive business, and when your contract price and terms are significantly better than the norm in the market, something usually goes wrong and the losses far exceed the potential profit you thought you would realize.”). In addition, in many large firms, retired traders come in a few days a week to serve as mentors and teachers to younger traders.

225. AXELROD, *supra* note 190, at 139.

4. Restoring Cooperation

Although there are certain types of disputes that are likely to end even long-standing cooperative contracting relationships, there are others in which it may be possible to restore cooperation even after it has broken down and parties are negotiating in the shadow of their legal rights. In this latter class of disputes, the industry's decision to maintain the availability of both monetary and nonlegal sanctions may make the restoration of cooperation at least slightly more likely by giving transactors who are contemplating arbitration an additional incentive (beyond mere avoidance of the deadweight cost of dispute resolution) to settle their differences and enter into another transaction, thereby increasing the likelihood that their trading relationship will continue.

Consider a situation where a contract is breached, liability is clear, and the parties know that if the case goes to arbitration, the breaching party will be ordered to pay $\$D$ in damages and the aggrieved party will be able to impose a reputational loss of $\$L$ on him as well. In such a situation, if the breaching party views the aggrieved party's threat to impose $\$L$ in reputational harm as credible,²²⁶ he would be better off

226. Given that reputation-based NLSs such as strong negative gossip are costly for an aggrieved party to impose and result in no direct pecuniary benefit to her, it is important to explore why, apart from a strong retributive instinct (something that is present in many instances), her threat to impose them could ever be credible. Consider a situation in which a buyer (B) is trying to decide whether to impose such a sanction on a breaching seller (S). If B imposes the sanction, it has two distinct effects. First, it imposes a cost on S without resulting in any direct pecuniary benefit to B . Second, and perhaps more important, B signals to the market that she is likely to be willing to impose such sanctions on those who breach contracts with her in the future. B 's signal in this context is credible precisely because the sanction is costly for her to impose and results in no pecuniary gain to her. It would therefore be irrational for her to impose the sanction if she didn't plan to stay in the market long enough to reap the benefits of the enhanced "deterrence" she has purchased. As a consequence, when B imposes such a NLS, she signals to the market that she has a low discount rate, that is, that she is a cooperative type, and by implication, that she cares about obtaining performance rather than a remedy for nonperformance. However, when B imposes a NLS, she also signals to the relevant pool of market transactors that she is more expensive to deal with than previously thought. As a consequence, B 's decision to impose a NLS in one transaction will affect her future transactional opportunities.

To more clearly understand how B 's future opportunities will be affected, consider a situation where a B transacts with S s who all select their level of precaution against inadvertent breach at the firm, rather than at the transaction, level. This approach to precaution is common in the cotton industry. Most merchant firms keep different levels of inventory, have different degrees of diversification of their supply bases, and use a variety of different modes of transportation, each with its own associated risk of delay and quality harm, making their precaution levels largely exogenous as to any one contract, and only imperfectly observable to market participants. Further, assume that in any one instance of breach, B will have difficulty accurately distinguishing inadvertent breach after optimal precautions have been taken from the type of willful breach that transactors view as "laying down on a contract" and strongly indicative of a propensity to behave badly in any of a number of ways in the future. In such a situation, B will reason that if she imposes the NLS and sends the associated signal to the market, not all S s will respond to it in the same way. Merchant firms who take a low level of precaution ("bad types"), will now view dealing with her as being a great deal more costly, and while merchant-firms who take a high level of precaution ("good types"), will

agreeing to any settlement that cost him less than $\$D + \L . Conversely, because imposing a $\$L$ reputational loss on the breaching party will not increase her monetary recovery, the aggrieved party would be better off with any settlement in which she receives more than $\$D$.²²⁷ Both parties would therefore be better off settling for an amount greater than $\$D$ and less than $\$D + \L , than they would be going to arbitration. However, in order for such an agreement to be feasible, the aggrieved party must be able to credibly promise not to impose the $\$L$ in reputational harm, something that it is difficult if not impossible to accomplish through the addition of a provision to the settlement agreement. One extralegal way to accomplish this, however, is for the trans-

also view dealing with her as more costly, the expected increment of added cost to them is lower. Because the "good types" take more precaution, their probability of inadvertent breach is lower than it is for the bad types, so the expected value of the increased sanction is less for good types than it is for the bad types. The "good types" will therefore be more willing than the "bad types" to deal with *B*. From the perspective of the "good types," the fact that they face higher sanctions in dealing with *B* creates a benefit for them — since in order to obtain a higher price, they are faced with the challenge of establishing that they are "good types." Although a *S*'s reputation is partially, though imperfectly, revealed through the information about his reputation circulating in the market (and perhaps his association membership status), the ability of a *S* to communicate his "good type" status more credibly by willingly assuming the risk of a higher sanction is certainly furthered through the sorting engendered by *B*'s imposition of the NLS.

Once this sorting takes place, and a *B* who has imposed a quasi-multilateral NLS returns to the market to buy again, she will face a situation where fewer people will want to deal with her since she is now more costly to deal with (the "sorting effect"). However, those *S*s who do want to deal with her will be disproportionately good types — those with a lower probability of breach (the "quality effect"). In market contexts where the "quality effect" dominates the "sorting effect," *B*'s decision to impose the NLS against *S* can, up to a point, increase the value of the subsequent contracts she enters into with this and other *S*'s, thereby making it worthwhile for her to bear the cost of imposing the sanction.

In cotton markets, the "quality effect" should dominate the "sorting effect." The cash-market price of cotton can be obtained in a variety of ways other than search and the number of *S*-middleman merchants is very large in relation to the number of *B*-mills. As a consequence, the price effect on a *B* of dealing with a smaller number of *S*s is unlikely to be particularly significant. In contrast, the beneficial effect on the value of *B*'s contracts of dealing with higher quality contracting partners is likely to be significant — execution and coordination costs are likely to be lower, and the likelihood that cooperation, once established, will be maintained is also greater since, as the probability of inadvertent breach decreases, so will the magnitude of misclassification risk.

However, it is important to note that if the sorting effect were the only desired benefit of imposing the sanction, a similar effect could be achieved if *B* simply demanded the inclusion of a huge liquidated damages clause in her contract with *S*. However, given the industry's adoption of the perfect tender rule, and the fact that tender is never, in fact, perfect, the use of such clauses would, as discussed *supra* notes 147-149 and accompanying text, give *B* an incentive to declare that *S* breached solely to obtain this windfall, and while her incentive to do this would be constrained by her desire not to get a bad reputation for engaging in holdup, because it is difficult for other market participants to gauge the extent of the deviation leading to the rejection, this constraint would be highly imperfect.

227. If, however, the aggrieved party would get the benefit described *supra* note 226, from imposing the NLS of $\$L$, the minimum amount she would accept for settling rather than litigating, collecting damages, and imposing the NLS would be $\$D$ plus some additional increment representing the nonpecuniary benefit of imposing the NLS less the cost of doing so.

actors to immediately enter into another contract.²²⁸ An aggrieved party's claim that the breaching party is not to be trusted will not be believed if the breaching party can produce a contract demonstrating that the parties are continuing to deal with one another. Thus, the \$L reputation loss is a joint benefit the parties can share if they continue to do business with one another. The availability of the hybrid-sanction encourages the transactors to deal with one another again, relative to a purely monetary sanction of the same magnitude, and may therefore help transactors restore cooperation even after it has broken down.²²⁹

The MCE arbitrators sometimes render decisions in a form that can be understood as an attempt to encourage the restoration of cooperation. In situations where they think the parties can continue to work together, they sometimes render a partial decision, leaving some aspects of the outcome to be agreed on by the parties. In one case, after deciding liability, the opinion "direct[ed the parties] to equitably settle the costs of damages and reasonably incurred expenses."²³⁰ The arbitrators' handwritten draft of the decision (filed with the case record) explains that the idea is for Firm A and Firm B to "work together to equitably settle," which suggests that forcing the parties to deal with one another face-to-face may be viewed as a way to lessen tensions and to reestablish trust. An MCE executive confirmed that restoring cooperation is an important reason these types of decisions are made.²³¹ Although there is nothing in the opinion of the arbitrators or any of the applicable rules that says what happens if parties who are directed to agree on damages or any other post-arbitration issue cannot, arbitrators' general distaste for repeat litigants creates at least subtle pressure for them not to return to arbitration.

228. Although the magnitude and structure of the hybrid sanctions available in the industry could be replicated through an ordinary decoupling scheme in which a portion of any recovery is paid to the association's treasury, the incentives created by the association's recourse to hybrid monetary and nonlegal sanctions would not be replicated. The decoupled monetary sanction would not succeed in bonding interior contractual promises nor would it create any additional incentive for the parties to enter into a subsequent transaction and thereby potentially restore their cooperative dealings. In addition, the absence of the NLSs would make it difficult for the transactors to vary their written agreements through credible extralegal understandings.

229. This might have been more important in the past when both merchant and mill concerns were smaller and emotions were an important reason disputes went to arbitration.

230. MCE Case No. 840 (1991); *see also* MCE Case No. 827 (1975) (holding, in the context of a multi-person and multi-country string trade, that the gin, not the defendant merchants, was at fault and directing the defendant to "give full support to [the plaintiff] in their efforts to collect this claim"). Sometimes MCE arbitrators try to pressure the parties to work out their problems before a hearing. *See* undated memo in case file for MCE Case No. 838 (1991) (noting that "[a]t Meeting on August — 13, [sic] 1991, the firms were asked by the committee to please make every attempt to deliver, class, and accept the cotton due on this contract [sic].") They were talked to by several members of the committee and given a "two week deadline").

231. Telephone Interview with MCE Executive (Feb. 1997).

5. Conclusion

For over a century,²³² the cotton industry has succeeded in developing rules, norms, and institutions that have made it possible for transactors to create and maintain remarkably cooperative contracting relationships.²³³ At the early stages of contracting relationships, the reputation-based NLSs, whose use and availability is facilitated by industry institutions, play an important role in facilitating cooperation by supplementing monetary remedies and bonding extralegal understandings. As the transactors' relationship develops, however, these sanctions decline in importance as the threat of terminating a mutually beneficial relationship becomes an increasingly powerful motivator of cooperative behavior. The reputation-based NLSs, however, remain in the background throughout the life of the relationship. They both constrain transactors' incentives to deviate from interior promises, and become relevant to transactors' decision making if they are consider-

232. See Perre Magness, *Memphis History Woven in Cotton*, COM. APPEAL, May 11, 2000, at CC2 (noting that the MCE was organized in 1873, and that by 1900, the "Exchange absolutely controlled the cotton dealings of the Memphis merchant and provided for arbitration of any differences that arose among its members over sales delivery, or character of the cotton prescribed in sales contracts").

233. Over the past ten years, however, technological advancements and other market changes have occurred that may, over the long run, undermine the ability of industry institutions to promote cooperation. Changes in mill production methods have made certain types of flexibility much more costly. New mill equipment is more sensitive to small differences in cotton quality. Mills producing certain types of goods have therefore become much more exacting and much less flexible about the precise quality of goods delivered. In addition, as mills have adopted just-in-time inventory methods, on-time delivery has become more important. Even small delivery delays can cause costly shut downs of production runs. This change in inventory control methods, combined with other technological innovations that have greatly increased the productivity of mill runs, has increased the cost of responding flexibly to quality shortfalls by negotiating a price adjustment, or to delays by accepting goods late and waiving applicable fines. It has resulted in a situation where even short shut downs can lead to large losses. As the cost of flexibility increases, the likelihood that cooperation, once established, will break down also increases, particularly where, as in cotton trading, the probability of certain types of inadvertent breach is high.

Another change that may affect the likelihood that cooperative relationships will arise and endure is the introduction of the relatively objective High Volume Instrument ("HVI") method of grading cotton. Although HVI classing is too expensive to use on every bale, its cost is going down and it may soon supplant reputation as the more desirable bond of quality. Since the need to rely on reputation to bond quality made the marginal cost of relying on it to bond additional obligations quite small, when HVI classing becomes inexpensive enough to use in everyday transactions, the marginal cost of using reputation to bond other aspects of these transactions will increase and it is possible that a rapid shift to more formal contracting methods will result. On the other hand, because HVI reduces misclassification risk, it may make existing cooperative relationships somewhat more stable.

Finally, the move from small firms to huge concerns with multiple agents buying and selling for their accounts may also undermine the maintenance of cooperation by making agents less willing to be conciliatory when disputes arise. As one merchant who had been in the business for a long time explained, today "people are more insistent on proving that they are right even when they are wrong, primarily since there is a perceived need to cover your tail within your own company since jobs are no longer life-long as they used to be." Telephone Interview with Merchant #9 (July 1996).

ing making or responding to a decision to enter an end-game situation. Together, reputation-based NLSs and the threat of terminating a valuable bilateral relationship work in tandem with the PLS's provision of monetary remedies (which make pure price volatility a largely unprofitable reason to breach a contract) to support highly cooperative contracting relationships. The stability of these contracting relationships may be due, in large part, to the fact that the framework the industry has created to support them has more than one feature that can satisfy (or partially satisfy) most of the conditions that are generally associated with the emergence and maintenance of cooperative trading relationships. By creating these redundancies in the infrastructure of trade, the industry has reduced the likelihood that real-world events that undermine the working or existence of a particular rule, norm, or institutional feature, at a particular time or within a particular relationship, will lead to the breakdown of established cooperative relationships. In addition, the stability of this and other cooperative-based commercial systems may also be due, in whole or in part, to the fact that social norms of honor, particularly when reinforced through group activity and a basic human desire to think of one's self as trustworthy,²³⁴ are more powerful motivators of transactional behavior than economic models of behavior typically assume.²³⁵

III. CONCLUSION

This Article has explored in some detail the complex private legal system that the cotton industry has created to govern transactions among its members. It has sought to identify some of the more important benefits created by the system in an effort to better understand the reasons that the industry has found it advantageous to opt out of the public legal system. It has also attempted to identify the types of benefits that can be created through the use of private institutions that cannot be fully replicated through private contracts and the use of public institutions. However, the Article's exploration of the benefits created by the PLS reveals quite clearly that many of its more important benefits are contingent in whole or in part on the industry's efforts not only to provide a well-developed legal infrastructure to support trade, but also, and perhaps more importantly, on its efforts to maintain and strengthen the social and informational infrastructures of trade, efforts that enable individual transactors as well as the system as a whole to harness the force of reputation-based NLSs. Recognizing

234. For a discussion of these considerations in commercial behavior, see generally David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 HARV. L. REV. 373 (1990).

235. This point is forcefully made in Robert Cooter & Melvin Eisenberg, *Fairness, Character and Efficiency in Firms*, 149 U. PA. L. REV. 1717 (2001).

the importance of these reputation-based forces suggests that the barriers to the creation of a PLS that is as successful as the cotton industry's system are far greater than merely overcoming the collective action problems of funding the creation and operation of a PLS. Nevertheless, even in the absence of a well-developed social and informational infrastructure of trade, such private commercial law systems can offer transactors, in a variety of industries and transactional contexts, benefits that are either unavailable or only available at great cost through the public legal system. Identifying the many benefits that PLSs have the potential to create suggests that it might be desirable for the public legal system and legislature to actively encourage their creation, or, at a minimum, remove impediments to their operation,²³⁶ especially since in addition to providing significant benefits to industry transactors, they are, in the main, socially beneficial,²³⁷ especially if certain limited regulatory oversights are put into place.²³⁸

236. For example, under the Federal Arbitration Act and most state arbitration acts, arbitrators are bound to decide cases by applying the law. *See* Ware, *supra* note 73. As a consequence, in industries where social bonds are not strong enough to prevent recourse to the courts, PLSs cannot adopt written rules that conflict with the UCC, something that the study of merchant-run PLSs suggests that it might be highly desirable for them to do. *See* Bernstein, PALGRAVE, *supra* note 65; Bernstein, *Merchant Law*, *supra* note 60; Lisa Bernstein, *The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study*, 66 U. CHI. L. REV. 710 (1999).

237. There are a number of reasons to think that the cotton industry's PLS is socially desirable from an economic point of view. First, absent information problems or externalities, neither of which are present in this industry, *ex ante* agreements to resolve disputes through binding alternative dispute resolution generally increase social welfare. *See* Steven Shavell, *Alternative Dispute Resolution: An Economic Analysis*, 24 J. LEGAL STUD. 1 (1996). The presence of coercion or duress is another reason that *ex ante* agreements to use ADR may not be socially beneficial. Although the fact that most cotton associations require their members to arbitrate disputes with other members as a condition of membership might be viewed as coercive, because transactors view other, unrelated association benefits as nearly indispensable, the available evidence suggests that industry participants not only view arbitration as a desirable alternative to litigation, but also consider it one of the primary benefits of trade association membership. Second, the PLS and the other institutional arrangements that support it appear to promote transactional efficiency without creating barriers to entry or other serious anticompetitive effects. Although an industry's decision to rely on reputation-based nonlegal sanctions does create some barriers to entry, since it takes time to establish a reputation, the availability of association membership, which provides newer transactors with a valuable piece of non-relationship-specific reputational capital, lowers these barriers. In addition, from the time of their founding until the present, these associations have gone to great lengths to increase the size of their memberships, consistent with the goal of ensuring that only transactors of good repute were admitted. *See, e.g.*, President's Address, Minutes of the SCSA Annual Meeting (Apr. 18, 1936) ("Each member should make it his business to see that all of the responsible cotton men in his locality are informed as to the benefits which the shippers' associations have secured not only for their own members but for the trade as a whole. This is another matter which the incoming administration would do well to specialize on."); Minutes of the SCA Annual Meeting (Apr. 5, 1957) ("The Southern Cotton Association is designed to effectuate a cohesiveness of our segment in our territory. The groundwork for that lines [sic] in keeping our enrollment at a high level. The best 'weapon of enrollment' we can employ is the member-to-prospect contact. Let's make use of it."); Minutes of the ACA Fall Board of Directors' Meeting (Oct. 11, 1980) ("The Secretary advised the Directors that he had secured the names of nonmembers of the Association and had requested various members by regions to make the necessary contacts in an effort to

build-up our membership.”); ACA Circular Letter No. 10 — 1994/1995 (Sept. 27, 1994) (exhorting members to assist in recruiting new members). Moreover, the only association that explicitly limits the size of its membership is the MCE whose By-Laws provide for a maximum of 132 members. MCE CONST., Art. VI, § 1. In the past, this limit imposed a binding constraint that led to a secondary market in memberships. *See, e.g.*, Telephone Interview with MCE Executive (Feb. 1997) (“In the old days the value of membership might be tens of thousands of dollars.”). In recent decades, however, this ceiling has not restricted admissions. The Exchange currently has only ninety member firms, and the tremendous consolidation that has taken place in the industry over the past two decades suggests that this membership limit is unlikely to impose a meaningful constraint in the future. Third, most of the group and individual benefits created by the system — such as the reduction in the caseload of the public courts, the reduction in the deadweight cost of disputing, and the emergence of cooperation — are also socially desirable.

Fourth, the existence of these domestic institutions, which are part of a network of institutions that operate all over the world, facilitates international trade. In the absence of these institutions, many transactions involving developing and formerly socialist countries might not occur because of the risk of hold-up, the weakened force of bilateral reputation bonds and nonlegal sanctions, and the difficulties of obtaining and enforcing judgments. In addition, the cost of dealing with foreign transactors, even in countries with well-developed legal systems, would also be quite high if the deals were governed by public legal systems. Enforcement problems would remain and the applicable laws would still have to be determined by complex choice of law and jurisdictional rules. In addition, a merchant dealing in many countries would have to learn the law in all of them. In contrast, the interlocking web of institutions that comprise the cotton industry’s PLS, reduces or lowers these barriers to trade by enhancing the strength of group-imposed reputation sanctions, and by providing simple sets of rules to govern transactions and well-run adjudicatory fora that resolve disputes around the world. The cotton industry has developed a number of additional norms and institutional features to attempt to deal with these problems and to facilitate the use and effectiveness of reputation-based NLSs and, at least to some extent, the force of bilateral repeat dealing incentives in transactions between U.S. merchants and overseas buyers. For example, the American Cotton Exporters Association and The World Cotton Exporters Association, maintain “a list of those parties engaged in the purchase and sale of cotton who have been reported by an exporter as being in default of an outstanding export contract and, where indicated, have also failed to honor a technical arbitration award issued by a recognized trade body.” http://www.acsa-cotton.org/About_ACSA/Search%20Rules/about_acsa.html. Before listing a person, however, these groups follow strict rules designed to assess the legitimacy of the request for the listing, yet another institutional safe-guard against the misuse of reputation-based NLSs. The list itself is freely available on the internet. This list is exempt from the United States antitrust laws under the Webb-Pomerine Act, 40 Stat. 516 (1918), as amended 15 U.S.C.A. § 61-65 (1987); *see also* PHILIP AREEDA & LOUIS KAPLOW, ANTITRUST ANALYSIS: PROBLEMS, TEXT, CASES 160 (1988) (under the “Webb-Pomerine Act, Congress exempted from the antitrust laws agreements or acts in the course of export trade by an association entered into for the sole purpose of engaging in such trade”). The only way to get off the blacklist is to pay 100% of your obligation. According to informal norms, once you are on the list, your creditor is prohibited from settling with you for less than full payment or he will be informally blacklisted. Although the bar on settlement for less than full payment after appearing on the list is imperfectly enforced, this hands-tying arrangement nevertheless increases the aggrieved seller’s bargaining power which may provide a partial counter-balance to the fact that he is the transactor most vulnerable to hold-up under the contract. (Source’s name withheld on request.) In addition, the industry has taken steps to make bilateral reputation sanctions more effective. Attempting to use the force of these sanctions in international transactions is more problematic because transactions are larger, the principals to these transactions often do not meet face-to-face, social ties among transactors are weaker, and repeat-dealing is less common. However, some bilateral reputation effects are created in the market through the use of overseas company representatives and brokers. Both the brokers and representatives share information about the behavior of particular buyers, and when one has repeated bad experiences with a company, the others respond with an informal boycott or slow-down of trade. The presence of large numbers of brokers in the market is remi-

niscent of the earlier days of the domestic trade. Although in some markets, brokers' main function is to communicate price information and to bring buyers and sellers together, in other markets, particularly in the past, one of their primary functions was to serve as reputation intermediaries. See, e.g., Bernstein, *Diamonds*, *supra* note 133, at 133 (discussing the role of diamond industry brokers in reducing the pre-transaction search cost of obtaining reputation-related information).

Finally, it is important to note that one critique that is commonly leveled against private adjudication, namely that it creates external social costs by depleting the future stock of judicial precedent, should not be viewed as a viable argument against the cotton industry's PLS. Harry T. Edwards, *Alternative Dispute Resolution: Panacea or Anathema?*, 99 HARV. L. REV. 668, 677 (1986) ("The concern here is that ADR will replace the rule of law with nonlegal values. . . . [and that] by diverting particular types of cases away from [court] adjudication, we may stifle the development of the law in certain disfavored areas of the law."); Owen M. Fiss, *Against Settlement*, 93 YALE L.J. 1073, 1085 (1984) ("A settlement [as a form of ADR] will thereby deprive a court of the occasion . . . to render an interpretation," in establishing rules and precedents); John V. O'Hara, *The New Jersey Alternative Procedure for Dispute Resolution: Vanguard of a 'Better Way?'*, 136 U. PA. L. REV. 1723, 1745-51 (1988) ("Arbitration can hinder the ability of courts to establish rules and can prevent development of new areas of the law such as intellectual property."). Although the existence of the PLS does slightly reduce the number of judicial opinions issued, this effect is likely to be small. Even if cotton disputes were resolved in court, given the highly fact- and industry-specific issues they raise, it is unlikely that an opinion would be written and precedent created. Moreover, to the extent that the creation of precedent or the clarification of existing rules is considered socially desirable because of its prospective effect on primary contracting behavior, William M. Landes & Richard A. Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUD. 255 (1979), the cotton industry's private tribunals are likely to create more social benefits of this type than do public courts. Although the opinions of these tribunals are not formally accorded precedential value, they nevertheless have a strong effect on contracting behavior, particularly when combined with industry efforts to circulate, report on them, and educate members about their content. This effect on primary behavior may be far stronger than the effect of state trial court decisions, especially those that are rendered in unpublished opinions. As for evolution of the rules themselves, industry arbitration tribunals sometimes note in their opinions that trade rules need to be clarified or amended, thereby playing a role in the rule clarification function that is said to be one of the primary benefits associated with common law decision making.

238. Although at present, industry-run PLSs do not, standing alone, create antitrust problems, the availability of the antitrust laws to ensure that the associations do not engage in anticompetitive behavior may be important. In addition, state arbitration laws that require some minimal procedural protections before an award is enforceable also enhance the functioning of private systems. However, there are some types of regulatory oversight that are viewed as socially desirable for reasons having nothing to do with commercial law that may make it more difficult for new industries to create PLSs that are also able to capture all the benefits associated with a strong infrastructure of trade. For example, antidiscrimination laws make it more difficult, if not impossible, to maintain socially, ethnically, or gender-homogenous associations, especially when those groups command economic power.