The National Agricultural Law Center

University of Arkansas
NatAgLaw@uark.edu | (479) 575-7646

An Agricultural Law Research Article

Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms, and Institutions

Part II

by

Lisa Bernstein

Originally published in MICHIGAN LAW REVIEW
99 MICH. L. REV. 1724 (2001)

www.NationalAgLawCenter.org

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 wilfulness 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 minimized[222] — 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 though 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 con-tract [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.