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SHOULD THE LAW IGNORE COMMERCIAL NORMS? A COMMENT ON THE BERNSTEIN CONJECTURE AND ITS RELEVANCE FOR CONTRACT LAW THEORY AND REFORM

*Jason Scott Johnston**

Professor Bernstein's study[1] of the interaction between private law and norms in the cotton industry is the latest installment in her ongoing investigation into the relationship between law and norms in trades ranging from the diamond market to grain and feed markets. Her incredibly detailed and thorough exploration of private lawmaking and commercial norms — and their interaction — stands as one of the most significant contributions to contract and commercial law scholarship made in the last half-century. The cotton industry study upon which I focus in this Comment not only reports fascinating findings about dispute resolution practices, but also presents a number of intriguing and complementary theoretical insights into those practices. Bernstein's empirical findings call into question some of the fundamental results in the economic analysis of contract law, such as the theory that expectation damages induce efficient breach of contract. Her central induction from her discoveries about cotton industry practices is that the best way for the law to encourage the development of extralegal norms of commercial reasonableness and the enforcement of those norms via commercial reputation may be, paradoxically, to make those norms irrelevant in formal dispute resolution. This hypothesis — which I dub the "Bernstein Conjecture" — suggests that the underlying methodological supposition in Article 2 of the Uniform Commercial Code — that the law should mirror or reflect actual commercial norms — may in fact be destructive of the very norms it seeks to incorporate. This is no small implication. For this reason, after beginning with a few methodological quibbles, the bulk of this Comment focuses on the Bernstein Conjecture. I first develop an informal but quite general analysis of the role of the law in deterring commercial opportunism, and I then focus more precisely on identifying the social and market context in which the Bernstein Conjecture is likely to hold.

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1. Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724 (2001).

I. METHODOLOGY AND SIGNIFICANCE

A. *A Peculiar, but Important, Empiricism*

Bernstein's paper is laudably ambitious. She explains the strategic logic behind the cotton industry's mix of private lawmaking institutions and nonlegal sanctions, and she theorizes about the lessons that may be drawn from the cotton industry for commercial law more generally. The paper nicely integrates theory with evidence. This ambitious integration, however, also tends at times to obscure the fascinating empirical questions and answers provided by Bernstein's study. Regardless of whether one is persuaded that Bernstein has really succeeded in explaining cotton industry practices, the empirical evidence that she has uncovered about those practices has some very important implications for contract law.

Before discussing the implications of Bernstein's findings, a brief methodological digression is in order. Bernstein's empirical data is primarily qualitative. It consists of recorded interviews with cotton industry traders (apparently done mostly over the telephone) and arbitration case files. Her characterization of the data is likewise qualitative. Sometimes this kind of characterization of the data is inconsequential. For instance, she says that many years ago, prior arbitration opinions were "sometimes" mentioned as guiding authority but today are "rarely" mentioned.[2] Bernstein does not tell us precisely what she means by "sometimes" and "rarely." The reader is left to infer that these terms are being used in a relative sense, relative to the frequency with which one might expect to see references to prior opinions in the published judicial decisions. The vague descriptors "sometimes" and "rarely" do not cause any trouble for Bernstein here, primarily because the role of precedent in cotton industry arbitration is peripheral to Bernstein's main claims about arbitration's function in the cotton industry.

More troublesome is her qualitative characterization of private law adjudication in cotton arbitration proceedings. Bernstein repeatedly characterizes as "formalistic" the reasoning in cotton arbitration decisions.[3] She claims that although parties' briefs "often make arguments based on good faith . . . , notions of good faith and fairness do not appear to affect case outcomes."[4] She says that even though one set of formal trade rules (the Southern Mill Rules — "SMRs" — that govern merchant-to-mill transactions) explicitly directs arbitrators

2. *Id.* at 1730 n.30.

3. *See, e.g., id.* at 1735, 1737-38.

4. *Id.* at 1734 & nn.51-53.

to look to industry custom to fill gaps in contracts, "unlike courts[,] . . . arbitrators are reluctant to find that gaps exist and they do not permit custom to trump or vary trade rules or explicit contractual provisions."[5] Another important set of formal trade rules (those of the Memphis Cotton Exchange — "MCE" — governing contracts between traders) is silent on the role of custom, but she says that arbitrators in this system do not actually take custom into account, as evidenced by the fact that custom is mentioned only three times in MCE opinions over the 1944-1991 period.[6] Similarly, she finds custom mentioned in only four of the forty-two B.A. opinions over the 1929-1951 period.[7] Bernstein in fact cites the ninety-one instances in which cotton arbitrators apparently did attempt to craft split-the-difference, compromise results because they felt that such a result was fair.[8] It is difficult to judge the significance of these opinions, just as it is difficult to assess her report that custom is infrequently mentioned in arbitral opinions. The problem is that the comparison between the court system and cotton industry arbitration is left unquantified: there is no comparison between, for instance, the rate at which courts refer to custom in cotton arbitration versus the rate in some sample of judicial opinions applying Article 2 of the Uniform Commercial Code.

Yet Bernstein clearly means to contrast the way cotton arbitrators decide cases under formal industry trade rules with the way in which courts decide cases under the Uniform Commercial Code: cotton industry arbitrators steadfastly and formalistically follow bright-line trade rules, while courts applying Article 2 roam about through a jungle of oral testimony about industry and relational norms on a Quixotian search for commercial "reasonableness." These are very important but also very broad qualitative characterizations. They are, moreover, the sort of qualitative judgments that define traditional, doctrinal legal scholarship. With the proliferation in recent years of "interdisciplinary" legal scholarship — law and economics, law and behavioral economics, law and norms, law and society, law and history, law and critical theory, and so on — doctrinal scholarship has fallen rather out of fashion. Doctrinal scholarship is perceived by many cutting-edge legal academics as sorely lacking in "rigor." In at least one crucial way, however, doctrinal analysis is really very scientific. Because they are interested mostly in persuading the reader that a particular recent opinion was sensible or foolish and ought to have limited or vast precedential effect, doctrinal scholars usually find it necessary to talk about judicial opinions at great length. Even in the

5. *Id.* at 1736.

6. *Id.* at 1736.

7. *Id.* at 1736 n.63.

8. *Id.* at 1734 n.52.

text of their articles, they really get into the guts of opinions, often quoting long passages. At the end (or even before the end if the reader does not have the stamina to get that far), the reader is in a pretty good position to assess the strength of the author's interpretive characterization.

Without getting into hermeneutic fine points, one can see how conventional doctrinal scholarship facilitates interpretive critique and thus enables a kind of qualitative verification process. One wishes that Bernstein's description of cotton industry disputing practices were equally amenable to critique. As it is, the reader does not really have a baseline — qualitative or quantitative — against which to assess her claims regarding the *empirical* superiority of the cotton industry's private law system to the Article 2 public law system.

There is, of course, the obvious functionalist argument that because cotton industry participants continue to use their own private law system rather than public legal system, they must find it superior. Below, I shall have more to say about the validity and implications of this kind of survival-of-the-fittest line of reasoning about alternative legal systems.[9] My present point is that Bernstein's methodology — an essentially qualitative analysis of case file and interview data — does not permit empirical evaluation of the relative efficiency of alternative dispute resolution systems. She presents data on the infrequency of arbitrated disputes in the cotton industry from which one can reasonably conclude, as she does, that the vast majority of disputes in that industry are resolved informally. But the vast majority of commercial contract disputes are also resolved informally and without litigation in the public legal system. Without some sense of contract dispute resolution in those industries that for whatever reason do not have their own private legal system, it is difficult, if not impossible, to draw comparative lessons from Bernstein's findings.

Bernstein's study is tremendously valuable, not for comparative purposes, but in revealing features of the cotton industry's private law system that neither standard doctrinal nor quantitative empirical work could uncover. Formal cotton industry trade rules are silent about the implied duty of good faith[10] and make course of performance and course of dealing between contracting parties irrelevant to an arbitrator's determination of their intentions.[11] The industry has adopted a simple and inflexible measure of damages given by the difference between contract and market price plus a one-half cent per pound penalty.[12] Failure to comply with an arbitral award is grounds

9. *See* Part III *infra*.

10. *See* Bernstein, *supra* note 1, at 1734 & nn.51-54.

11. *Id.* at 1735 & n.58.

12. *Id.* at 1733.

for expulsion from cotton shippers' associations and from the Cotton Exchange.[13] Membership in the association of cotton mills, however, is not affected by a mill's failure to comply with an award.

As for the significance of reputation within the cotton industry, Bernstein recounts a number of conversations with both growers and mill owners to the effect that reputation is "essential" to transacting within the industry.[14] Mill owners — cotton buyers — reported that because the quality of cotton is so "subtle and subjective," and yet they often make deals over the phone without physical inspection of the goods, it is crucial that the buyer know about the seller and be able to rely on his word regarding quality.[15] A cotton market participant's commercial reputation depends on whether he has performed as promised (has the mill promptly accepted delivery? has the merchant delivered the promised quality of goods on time?), as well as on his willingness to be flexible in the face of changing circumstances, even to the point of being willing to renegotiate key terms of the deal.[16] Reputation must be verifiably communicated to be valuable. Such information transmission was a simple social fact in the rural, small-town south in which the industry arose, where mill owners were town leaders, and where the members of the Memphis Cotton Exchange saw each other daily and "viewed themselves as being part of the same club."[17] One of Bernstein's most interesting and important discoveries is the deliberate production in recent years of more formal institutions for transmitting information about industry norms and individual reputations for complying with those norms. An eight-week summer Cotton Institute instructs new merchants in the content of the trading rules. Although norm violations are not formally determinative of arbitrators' decisions, (some) arbitration opinions are circulated within the industry, and these often include what Bernstein describes as "preachy statements about what is and what is not acceptable business behavior."[18] Independent private publications as well as trade association circulars now rate the financial responsibility of cotton shippers and buyers.[19]

13. *Id.* at 1737.

14. *Id.* at 1746.

15. *Id.*

16. *Id.* at 1744.

17. *Id.* at 1750.

18. *Id.* at 1773.

19. *Id.* at 1753.

B. *Law's Role in Contract Breach and Renegotiation: The Bernstein Conjecture*

Bernstein's findings about cotton industry dispute resolution practices alone carry some important lessons for contract law and theory. Perhaps most important is what Bernstein's conversations revealed about the way cotton industry participants understand contract breach. Bernstein's respondents clearly repudiated the notion that they were indifferent between getting damages for breach and receiving promised performance.[20] The respondents also provided an explanation for their unwillingness to accept breach and payment of damages as a substitute for performance: from a cotton mill's point of view, the reason for purchasing cotton forward, rather than on spot markets, is to ensure continuity and provide certainty. Similarly, cotton merchants shift risk from growers to themselves, but the risk to merchants themselves would be intolerable were they not able to shift risk downstream to mills.[21] For both merchants and mills, breach destroys the fundamental reason for contracting. Or, more accurately in terms of Bernstein's findings, while a single breach caused by unusual circumstances may be forgiven, a *pattern* of breach by a particular merchant or mill will not be forgotten. Such a pattern not only makes it foolish for the immediate victim to trust the breaching party again, but other market participants will learn of the pattern, and they, too, will avoid dealing with the offending party. Bernstein has discovered that, in the cotton industry, the legal damage measure is in a certain sense irrelevant. No matter what the damage measure might be, it simply cannot replace performance.

This is not to say that the formal cotton industry trade rules simply dispense with damages for breach. Rather, as Bernstein explains in some detail, because of the complexity and cost of getting expectancy-based damages, cotton industry trade rules provide a very simple, low-cost damage measure — the difference between contract and market price plus a fixed per-pound penalty.[22] Especially given the low-cost, streamlined procedures in cotton industry arbitration, these market-difference damages would appear to do a relatively good job of compensating for and deterring breach motivated solely by big swings in market price. But no measure of damages can really compensate a trader for dealing with someone with a known propensity to find lots of reasons, whether real or concocted, for degrading performance (by, for example, delivering late or poor quality goods, or by refusing to

20. *Id.* at 1750.

21. *Id.* at 1776.

22. *Id.* at 1756.

accept goods without a discount). Hence, it is not legal but extralegal sanctions that deter such patterned opportunism.[23]

This is an exceptionally important empirical finding. The economic analysis of contract law begins (both historically and often analytically) from the demonstration that perfectly compensatory expectation-based contract damages create an incentive for efficient breach — breach when performance would generate lower net value than some alternative performance (including not performing at all, as when performance cost rises dramatically).[24] Bernstein's study reveals that it is precisely in those markets where forward contracts are most important — volatile commodity markets — that efficient breach approaches utter nonsense. On such markets, the point of having a contract is to reduce uncertainty and guard against unanticipated market price changes. Were every such price change to trigger breach on one side of the market or the other (depending upon the direction of the market-price change), the market would literally disintegrate. However efficient the market's formal dispute resolution mechanism — and Bernstein presents plenty of evidence that the cotton industry's is highly efficient — such markets simply cannot wait for the consequences of breach to be remedied. They must not occur in the first place.

The fact that sophisticated cotton traders regard contract breach as a violation of industry norms should cause law and economics scholars to rethink seriously the relevance of the efficient breach model. Some of Bernstein's other findings make one doubt that law — whether public or private — matters much at all in industries like cotton that have strong systems of nonlegal sanctions. Bernstein reports that news of the outcomes of most arbitrated disputes between merchants quickly reaches other merchants, and that opinions of the Board of Appeals ("BoA") (deciding disputes between mills and merchants) are actually sent to all members of mill associations.[25] Even though the trade rules do not impose an explicit good faith requirement, arbitrators' opinions apparently quite often comment explicitly upon the commercial acceptability of the parties' behavior.[26] Given that arbitration results and opinions are quite widely disseminated within the industry, Bernstein is certainly correct in thinking that a party's reputation could suffer from the explicit condemnation of an experienced and knowledgeable arbitrator.[27]

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23. *Id.* at 1755-85.

24. For the classic analysis, see Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties, and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977).

25. Bernstein, *supra* note 1, at 1730.

26. *Id.* at 1734 nn.52-54.

27. *Id.* at 1768-69.

But even granting that arbitrators often include lots of very judgmental stuff in their opinions, stuff highly relevant to commercial reputation, it is hard to see how those opinions could in fact play an important role in reputation formation. First, not all opinions are available to nonparties. Bernstein does not explain why opinions handed down by the MCE (resolving disputes between merchants) are not made public,[28] while those decided by the BoA are actually sent to all members of the largest mill associations.[29] Second, there are very few cotton industry arbitrations at all — and even fewer where both parties are actually staying in business. Apparently the MCE and BoA each averaged about two arbitrations per year over Bernstein's study period,[30] while there were only twenty-eight merchant-mill disputes brought before the BoA over the twenty-one-year period 1975-1996.[31] Although Bernstein oddly does not provide this data, one suspects that a large fraction of arbitrations involves end-game situations, where, because of bankruptcy or death, the defendant is going out of business.[32] Bernstein's findings suggest that arbitration under the formal trade rules does not play a very large direct role in reputation formation.[33]

This is in fact consistent with Bernstein's own interpretation of the cotton industry interviews. She stresses that the primary significance of private law for the parallel world of commercial norms and nonlegal sanctions is not direct but rather indirect.[34] What is crucial about the cotton industry trade rules is their form: they provide a background of clear, bright-line performance obligations against which cotton traders bargain to resolve disputes and overcome unforeseen contingencies. Cotton traders have an incentive to behave reasonably not because formal cotton trade rules explicitly tell them to do so, but because if they don't, they will acquire reputations for opportunism and face fewer or less valuable trading opportunities in the future. Were the law to attempt to mirror commercial norms of reasonableness by requiring reasonableness, Bernstein concludes, it would severely hinder the process by which reputation develops and tend to destroy the system of nonlegal sanctions.

This in my view is Bernstein's central hypothesis. It is a brilliant and fascinating conjecture. If true of markets in general — rather than

28. *Id.* at 1730.

29. *Id.*

30. *Id.* at 1762.

31. *Id.* at 1728 n.18.

32. *Id.* at 1738-40 & nn.71-74.

33. This conclusion is reinforced by Bernstein's finding that the parties' names are redacted from the formal opinions.

34. Bernstein, *supra* note 1, at Sections III.3-III.4.

only those that bear structural similarities to the cotton trade — it would have powerful implications for public law reform. Its truth, however, is not at all obvious. For Bernstein's is a conjecture about how legal form — the choice between the cotton trade's bright-line obligations and the UCC's open-textured standards — affects the evolution and maintenance of commercial norms and nonlegal sanctions for their violation. As I explain below, the relationship between legal form and the evolution of commercial norms is complex, depending upon market and social structures that are historically contingent and highly contextual. Before exploring her conjecture further, one must first clarify more generally the relationship between legal and extralegal sanctions.

II. Law, Norms, and Contractual Opportunism

Perhaps the fundamental contribution of the Chicago school to the study of contract law is the insight that when courts take an open-textured approach and make contract obligations depend upon "reasonable" or "good faith" behavior, they remain imperfect.[35] True, courts will often correctly identify and sanction bad faith behavior, cutting both the cost (to the victim) and the benefit (to the perpetrator) of contractual opportunism, but they sometimes miss instances of bad faith, and they sometimes mistakenly conclude that a party has acted in bad faith when all it has done is exercise a clear contractual right. The victim of such a judicial error ends up uncompensated or must pay damages even though it did not in fact engage in bad faith. Such a damage award encourages opportunistic actors to make unfounded claims that the other party acted in bad faith. False positives thus increase both the cost (to the victim) and benefit (to the perpetrator) of contractual opportunism.

If the risk of false judicial determinations of bad faith is sufficiently low, then a legally enforceable duty of good faith and reasonable behavior may actually improve market efficiency. It may do so by lowering the barrier to entry created by established reputation. As Bernstein shows, especially when contract performance involves a significant subjective component and varies greatly across alternative contracting partners, market participants have a very strong incentive to learn about the quality of alternative contracting partners and to stick with those who establish a reputation for quality, fair dealing, and flexibility in the face of unforeseen circumstances. They are hesitant to take a chance with a new entrant to the market whose reputation cannot be ascertained. If enforced with sufficient accuracy,

35. Articles that elegantly set forth this insight include Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986), and Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947 (1989).

legal sanctions for bad faith behavior lessen the risk of going with such a new entrant, thus encouraging entry and helping to make markets more competitive.[36]

As a theoretical matter, therefore, judicial policing of contractual opportunism is likely to improve market efficiency only when courts narrow the forms of sanctionable opportunism to those that they can identify accurately. It is highly unlikely that courts can identify instances of "opportunism" premised solely upon the failure of one of the parties to comply with a relationship-specific norm of good faith that is based not upon trade customs but upon the peculiarities of the particular parties. Thus, Bernstein's finding[37] that course of dealing and performance are given no weight in cotton arbitrations has general significance. Arbitrators are no more informed regarding truly relationship-specific norms than are courts. Neither arbitrators nor courts can verify relationship-specific norms with sufficient accuracy to make it efficient to incorporate such norms into the law.

Bernstein's findings reveal the exclusion from cotton arbitrations even of those norms that are customary within the trade and that arbitrators, who are themselves experts in the trade, are therefore likely to know and understand. Inasmuch as violations of many of these norms would be verifiable instances of opportunism, what I have said thus far would seem to imply that cotton arbitration may be inefficiently ignoring customary norms. This is unlikely to be the case. The reason is that my analysis has only focused on private legal sanctions as a *complement* to nonlegal sanctions. Legal sanctions for verifiable instances of opportunism can effectively lessen the risk of dealing with a new entrant who has not yet acquired a reputation. But they also impact the process by which reputation is formed. Paradoxically, it may be much easier for parties to generate good reputations when the law does not require "good faith" behavior than when it does.

A formal demonstration of this claim is beyond the scope of this Comment,[38] but to understand the intuition behind it, consider the following simple example. Suppose that by behaving opportunistically and claiming that a particular delivery of cotton is inferior when it is not, a cotton mill might gain $100 above what it expected under the contract. If the rules applied in arbitration made such conduct

36. Legal sanctions are only effective against defendants with sufficient wealth to pay the expected judgment, but unlike reputation, information about a newcomer's balance sheet can be acquired with relative accuracy and at relatively low cost.

37. Bernstein, *supra* note 1, at 1735 & n.58.

38. The driving idea here is that if a party complies only because it is legally obligated to do so, then its reputation is not enhanced; the legal discretion to act in "bad faith" may be what makes good faith behavior a credible indicator that the party is cooperative. *See* Arnoud W.A. Boot et al., *Reputation and Discretion in Financial Contracting*, 83. AM. ECON. REV. 1165 (1993).

actionable as breach, and such conduct were verifiable with a high degree of accuracy, then the merchant could credibly threaten to sue over such opportunism and thereby deprive the mill of the $100 gain from opportunism. Under such circumstances, any particular mill's reasonable behavior would do nothing toward establishing the mill's reputation. The reason is that even if the merchant and mill were never going to see each other again, so that the game — the merchant-mill transaction — were not going to be repeated, the mill's dominant strategy would be to eschew opportunism. If the law is so effective that it deters even bad types from cheating, then failure to cheat does not reveal anything about a party's propensity to cheat.

The paradox is that in order to facilitate reputation formation, the law must allow some instances of verifiable cheating to go without legal sanction. This is not to say that the ideal regime would impose no legal sanctions for verifiable cheating. Ideally, the law would ignore all but the most grievous and dangerous forms of verifiable opportunism. By leaving minor instances of opportunism unsanctioned, the law sets up a game in which actors who have a high payoff from opportunism will reveal themselves by taking the opportunity. Bernstein's work shows that a history of cheating gets around very quickly in the cotton industry, triggering the two primary nonlegal sanctions: refusal to deal and refusal to cooperate.

That such nonlegal sanctions exist and are applied does not show that they effectively deter all cheating. By repeatedly cheating, a party reveals that it is relatively immune to the nonlegal sanctions of retaliatory cheating and boycott. The paradigmatic instance of such immunity is a monopolist: because the monopolist gets high rents, it can survive many rounds of retaliatory cheating with relative impunity, and because it is a monopolist, there is nowhere else for buyers to go.

Bernstein provides hints here and there that cotton mills may generally have a stronger bargaining position than merchants.[39] Still, Bernstein's description of the cotton industry suggests that the industry is far from being either a monopoly or a monopsony. But it is equally clear from her discussion that the cotton industry departs radically from the textbook description of perfect competition. Cotton merchants and mills appear to have highly individualized reputations. Her conversations reveal that sometimes a merchant or mill simply has to live with obvious and verifiable instances of opportunism. For this to be so, it must be that the market is not sufficiently thick for a single instance of opportunism to cause the cheater's elimination from the market. What Bernstein seems to have found is an equilibrium in

39. In an earlier version, Bernstein stated that there are "far fewer mills than merchants"; *id.* at 1747 (observing that most merchants operate on "very slim" cash flow margins).

which the market tolerates low levels of cheating, at least on the part of some powerful market participants. This should not be surprising, for on this view the strategic reason why the cotton industry's private law regime ignores some instances of low-level opportunism is precisely in order to create an opportunity for cheating to occur.

It is important, however, that the private law regime not ignore the most serious and potentially damaging instances of verifiable opportunism. This is true on both the cost (victim's) and benefit (cheater's) side. As Bernstein notes, even the most severe extralegal sanctions — ostracism and exclusion from the industry, a virtual commercial death sentence — are ineffective against a participant who is leaving the industry anyway. What she calls the end-game participants — those on the verge of bankruptcy, or family firms whose controlling member has died without an obvious successor — are immune to the ultimate extralegal sanctions of industry ostracism. These sanctions do not deny the benefits of opportunism to end-game actors. On the victim's side, the problem with extralegal sanctions — especially third-party refusals to deal in the future — is that they do not do anything to compensate the victim for her losses from opportunism. If there were no opportunity to get legal damages even for the most harmful instances of opportunism, then market participants would face enormous risk when dealing with firms that are undergoing difficulties and may be tempted by end-game opportunism.

III. IS FORMALISM RIGHT FOR EVERYBODY? BERNSTEIN AND PUBLIC LAW REFORM

There can be little doubt that Bernstein's work has generated interesting and important insights into private lawmaking and the interaction between legal (albeit private legal) sanctions and nonlegal sanctions. She clearly believes,[40] however, that her findings have implications beyond the world of closely knit merchant communities such as the diamond and cotton trades, and implications for public law reform. Granted that Bernstein has established that the private law of the cotton industry does not attempt to mirror the norms that govern work-a-day business relations, does this then establish that Article 2 of the Uniform Commercial Code rests on a fundamentally mistaken philosophy? Karl Llewellyn believed that by making decisions turn on arcane and formalistic determinations such as the location of title, the law of sales had gone badly awry. In drafting Article 2, he pursued the principle that the law of sales should as much as possible simply reflect

40. *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) (arguing that her findings on private legal systems cast doubt on Article 2's incorporation strategy).

commercially reasonable practice.[41] The Article 2 provisions that Bernstein marks as deviating most dramatically from the private law of the cotton trade — such as the priority given to course of performance and course of dealing in determining the parties' contractual obligations, and the general implied obligation of commercially reasonable conduct (the objective good faith obligation) — are prime instances of Article 2's general "Reflection" philosophy. The question is whether Bernstein is correct in thinking that the dramatic distinction between Article 2's open-textured reflection strategy and the apparently formalistic approach taken by the private law system in the cotton trade means that Article 2 ought to be reformed. Another way of putting this question is simply to ask: were the formalists correct? Are seemingly arbitrary and imperfect bright-line legal rules superior to the highly fact-specific effort to make the law mirror commercial norms?

A. *Why Social and Market Structure Matter*

The analysis from the previous section strongly supports Bernstein's critique of the Code's automatic absorption into a commercial contract of concessions and other adjustments made in the course of dealing or course of performance. Even if the parties intended for such concessions to in fact modify their future obligations, there is much too high a probability that courts will err in determining what the parties have actually done or said in their prior dealings. This high probability of error makes it too easy for a party who failed to get a particular term in the contract to insist afterward that although the contract does not say a thing about it, the term in fact was there, implied by prior dealings or performance.[42] Thus, course of dealing and course of performance do more to encourage opportunism than to prevent it. They discourage the very behavior that Article 2 as a whole means to encourage. As Bernstein argues, a merchant who reasonably agrees to renegotiate, or make other "forgiving adjustments" must worry that those reasonable adjustments will harden into fixed contractual obligations by virtue of the Code's

41. *See* Ingrid Michelsen Hillinger, *The Article 2 Merchant Rules: Karl Llewellyn's Attempt to Achieve The Good, The True, The Beautiful in Commercial Law*, 73 GEO. L.J. 1141, 1164 (1985); Zipporah Batshaw Wiseman, *The Limits of Vision: Karl Llewellyn and the Merchant Rules*, 100 HARV. L. REV. 465, 471 (1987).

42. For a very famous instance of this, see *Trident Center v. Connecticut General Life Insurance Co.*, 847 F.2d 564 (9th Cir. 1988) (where borrower argued for a contractual prepayment right on basis of specious ambiguity).

incorporation of course of performance and course of dealing as implied contract terms.[43]

This criticism of Article 2 does not, however, imply that the cotton industry's formalistic approach is correct for every industry. The choice of a formalistic private law by cotton industry participants may indicate its efficiency for that industry and hence the efficiency of a similarly formalistic approach for identical industries. The problem, of course, is that if an industry is really identical to the cotton industry in all economically relevant respects, then one ought to observe that industry participants have already contracted out of the public law system by adopting their own private law system. The failure to observe such a private law system is evidence either that an industry is not as similar to cotton as it might at first seem, or that important noneconomic factors account for the emergence of effective private law institutions. Both possibilities may severely limit the relevance of Bernstein's findings for general law reform.

Consider first the significance of an industry's social context. Bernstein's own work demonstrates the power of noneconomic factors in the evolution of systems of nonlegal commercial sanctions. Both the diamond and cotton trades she has studied in detail were historically very much closed worlds, with market participation limited to individuals from particular religious, ethnic, and/or family groups.[44] Group membership can be an extremely effective entry barrier. These entry barriers generate economic rents — supracompetitive profits. Such profits make the threat of expulsion from the industry enormously powerful. Provided that the market is relatively unconcentrated (given the ethno-religious constraint on participation), no participant is so crucial as to be beyond the threat of explusion, at least for sufficiently serious violations of industry norms.

That a requirement of ethnic group membership for participation in a particular trade can create an effective entry barrier does not explain how such trading communities arise in the first place. There is, however, abundant historical evidence for the following account.[45]

43. Section 2-202 of the U.C.C. explicitly endorses the use of course of dealing or usage of trade, *see* U.C.C. § 1-205, or course of performance, *see* U.C.C. § 2-208, to interpret the parties' contractual obligations.

44. In addition to Bernstein, *supra* note 1, see Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992) [hereinafter Bernstein, *Opting Out*]. Although not emphasized by Bernstein, *see id.*, the New York Diamond Dealers Club evolved in precisely such a social and cultural context. *See* ALBERT LUBIN, DIAMOND DEALERS CLUB: A FIFTY-YEAR HISTORY (1982).

45. *See* JANET T. LANDA, TRUST, ETHNICITY AND IDENTITY: BEYOND THE NEW INSTITUTIONAL ECONOMICS OF ETHNIC TRADING, NETWORKS, CONTRACT LAW AND GIFT-EXCHANGE (1994) (surveying rules of ethnic market intermediation groups); Bernstein, *Opting Out*, *supra* note 44; Avner Grief, *Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition*, 83 AM. ECON. REV. 525 (1993) (discussing rise of Maghribi Coalition in international trade).

Suppose that some small number of individuals begin to engage in trade in some commodity. Unsure of the reliability of nonlocal legal institutions, but desirous of expanding the geographic scope of trade, the traders have a very strong interest in minimizing the occurrence of disputes. They prefer to deal, either as agents or as contracting partners, with family members or other individuals of the same ethnic or religious group, because nonlegal sanctions are all that they have. The ultimate nonlegal (but still lawful) sanction is expulsion. Before any particular ethnic or religious group has come to dominate a trade, the threat of expulsion from the trade is weak — group members do not earn especially high rents, and even after expulsion from the group, an individual can still engage in the trade. What makes expulsion from the group effective at this early stage is that the group is not just a trading group, but also a social and religious community. For a believer, expulsion from a religious community may be worse than death. Insofar as human beings are social animals, social ostracism is always costly, and it is most costly at the extremes. Exclusion from a group that is itself discriminated against casts the outcast, provided she is identifiable, into the hell of isolated prejudice. Exclusion from a group that dominates society imposes tremendous indirect economic costs. The more fractured the society, the greater the cost of social exclusion. At the extreme, where society is just a collection of antagonistic groups competing over limited resources, expulsion may have severe consequences.[46]

Thus, before an ethnic or religious group has established dominance in a particular field of commerce, the noneconomic costs of group expulsion must be high for group expulsion to deter commercial opportunism effectively. This gives close-knit ethnic and religious groups a very large initial advantage in conducting trade. Over time, this advantage may be so great that such groups establish dominance within various lines of commerce.[47] In this way, group membership becomes a prerequisite to market participation. Group dominance of the trade makes the economic costs of expulsion even greater than the noneconomic social and religious costs. As economic sanctions

46. For evidence on ostracism as a technique of social control, and its harsh effects, in such an unforgiving environment, see RICHARD B. LEE, THE !KUNG SAN: MEN, WOMEN, AND WORK IN A FORAGING SOCIETY (1979).

47. When a group that begins to gain dominance in a lucrative trade has traditionally been discriminated against and is a political minority, dominant groups will react by attempting to legislate or otherwise gain control over the trade. From Jewish bankers in Europe to Chinese traders in South Asia, however, history shows that by the time such reaction begins, the once downcast group will often have acquired sufficient wealth and power to maintain and even enhance its economic and social position and rebuff the most costly reactionary action. *See* FRANCIS FUKUYAMA, TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY 93 (1995) (discussing the success of Chinese merchant families in maintaining authority); LUCIAN W. PYE, ASIAN POWER AND POLITICS: THE CULTURAL DIMENSION OF AUTHORITY (1985).

become primary, ethnic and religious affiliation tends to lose its significance for sanctions and to become important primarily by ensuring that information regarding opportunistic commercial behavior is quickly and accurately communicated to other market participants.

This account predicts one of Bernstein's most interesting empirical findings, that as both the insularity and local power of southern elites has diminished, the cotton trader and mill associations have found it necessary to manufacture their own institutions to replace the information-gathering and norm-communication functions previously provided by organic social and religious groups.[48] It also casts doubt, however, on her explanation of the differences between cotton and other commodities, such as grain. Bernstein maintains that cotton is special in that the quality of a particular lot of cotton is much more variable and subjective than, for instance, grain.[49] This makes it sound as if grain comes off the field in standardized, clearly differentiated grades that can be objectively determined. Yet as demonstrated by environmental historian William Cronon, there is nothing natural about the classification of grain and feed into standard grades.[50] As he recounts, prior to the advent of the railroad, grain was taken to market in sacks, and the contents of each sack "remained intact, unmixed with grain from other farms. Nothing adulterated the characteristic weight, bulk, cleanliness, purity, and flavor that marked it as the product of a particular tract of land and a particular farmer's labor."[51] The railroad changed all this: by rerouting settlement away from river valleys and toward railroad corridors, the railroad led to huge increases in both demand and supply. Even more crucially, by mixing hundreds of bushels of grain together in a single boxcar and then literally pouring it out into enormous grain elevators, the railroad severed the relationship between an individual producer and his product.[52] The individual grower now had an incentive to adulterate his own grain, mixing wheat with lower-cost materials such as rye and chaff to increase its weight, and thus its value, at elevator sales. It was to overcome this incentive that the Chicago Board of Trade imposed standardized grades.[53] The existence of reliable grades was moreover a direct consequence of the fact that the Board was equally balanced between buyers and sellers.[54] Wheat and other grains are the

48. Bernstein, *supra* note 1, at 1752-54.

49. *See id* at 1745-46.

50. WILLIAM CRONON, NATURE'S METROPOLIS: CHICAGO AND THE GREAT WEST 107-20 (1991).

51. *Id.* at 107.

52. *Id.* at 109-19.

53. *Id.*

economists' paradigm for a homogeneous good, but they are homogeneous only because technological revolutions in grain transportation and storage made standardized grades economically imperative, not because they are naturally uniform.

The history of grain standardization strongly cautions that an industry's or trade's economic structure is crucial in determining the relationship between the legal and extralegal worlds. Bernstein's investigations into the cotton and diamond trades are fascinating and valuable in large part because these are very unusual markets. They exemplify trades in which a relatively small and closely knit social group gained dominance, precisely the sort of trade in which one would expect extralegal norms to flourish. But as I argued above, the very success of such a group weakens the importance of its ethnic or religious affiliation. Gradually it is the prospect of losing the opportunity to make supracompetitive profits, rather than social ostracism, that becomes the strongest deterrent to opportunism. As Bernstein's cotton study shows, as the social group lessens in importance, market participants find it necessary to invest and produce substitute institutions that facilitate the formation and transmission of reputation; those created institutions, however, further weaken the functional value of ethnic and religious affiliation. As the historical evolution of the grain industry shows, once the number of market participants grows sufficiently large, individualized product or service reputation tends to vanish and standardized product grading replaces it.

B. *The Limited Lessons of Private Law for Article 2 Law Reform*

Much of Article 2 of the Uniform Commercial Code aims to supply default terms for commercial dealings on highly competitive markets for standardized products. It is very difficult for nonlegal sanctions to develop into a significant force against opportunism on such markets. To see why, suppose heroically that there exists some way of ensuring that none of the many market participants would deal with an identified opportunist in the future. Even then, exclusion from a competitive market costs the opportunist only the competitive rate of return.[55] Provided that there are sufficiently many such competitive markets with relatively low costs of entry, a cheater can simply

54. *Id.* at 119.

55. This result might seem to contradict the oft-cited result in Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981), that competition itself disciplines against opportunism. Their result, however, depends upon the assumption that sellers compete in a monopolistically competitive market with distinctly identifiable, branded products. Even more importantly, they do not consider multimarket settings in which opportunists can move from market to market.

continue to rove from market to market. Because it is easy to enter other markets, the primary nonlegal sanction of exclusion loses its bite. In such a world — the economist's ideal of many highly competitive markets — the equilibrium must be one in which there is a positive amount of opportunism in all markets.[56] Most importantly, even when feasible (that is, even when information about cheating does get communicated widely and cheaters can actually be identified), nonlegal sanctions have no effect on the equilibrium level of cheating.

This assumes that it is somehow possible to exclude an opportunistic buyer or seller from a perfectly competitive market. But perfect competition requires a very large number of buyers and sellers. And as the number of market participants increases, so too does the cost of communicating information regarding past instances of opportunism. Nor can other market participants easily observe "opportunism" directly. What Ellickson calls "third party" sanctions[57] (that is, future refusals to deal by market participants other than the person harmed by a particular instance of opportunism) are therefore often triggered by *reported* rather than observed instances of opportunism. As the number of market participants increases, however, it becomes increasingly less likely that any given recipient of a report of opportunism is professionally acquainted with the reporter and believes that the report can be trusted. Without reliable reports of opportunism, the third-party sanctioning system cannot work. And second-party sanctions — a refusal by the victim to deal again with the opportunist — are a very weak sanction indeed on thick, competitive markets, where there are many fungible contracting opportunities.

When there are competing markets, participants in any particular competitive market do of course have a direct interest in keeping the level of opportunism relatively low so as not to drive away potential customers. But extralegal sanctions do not do the job for them. This is clearly illustrated by American stock markets, which engage in organized and formal self-regulation as a means of policing opportunism.[58]

There is no reason to tailor legal rules to facilitate reputation formation when market structure does not allow for reputation formation. In a world with many highly competitive markets across which participants move easily and with relative anonymity, nonlegal

56. With the equilibrium frequency of opportunism given credible expulsion determined by the condition that the return to opportunism net the cost of entering a new market after expulsion is equal to the return from staying in the original market but refraining from opportunism.

57. ROBERT C. ELLICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 128 (1991).

58. *See, e.g.*, Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997).

sanctions are weak and/or ineffective. In such markets, the argument for bright-line rules — that they facilitate the evolution of reputation-based extralegal sanctions — does not apply. Hence in such markets there is good reason for the law to be more activist in attempting to discern and police contractual opportunism. To the extent such activism is enabled by Article 2's open-textured standards, those standards are economically justified.

This is not to endorse every open-textured standard found in Article 2. It is crucial to stress that even in such markets, it remains true that false positives — false findings of opportunism — can convert legal rules designed to deter opportunism into instruments of opportunism. Hence, on competitive markets, it is appropriate for legal rules to attempt to mirror and require reasonable commercial behavior, but only those sorts of such reasonable behavior that can be verified accurately by courts. Inasmuch as Article 2 defaults to the market to determine what is "reasonable," it conforms to this prescription. Insofar as Article 2 endorses the search for course of performance and course of dealing, however, it becomes an instrument for rather than a tool against contractual opportunism.

Article 2 applies equally to the polar situation of a highly customized contract between a buyer and seller with market power. As Bernstein's work demonstrates, participants in such markets quickly acquire reputations, and the market structure is such that information about a particular actor's behavior may be communicated quickly and credibly to a large fraction of the market population. The problem is that if an actor has too much market power, then nonlegal sanctions against that actor may lose their credibility and effectiveness. If, for instance, there is a monopoly in the production of a good that is a vital downstream input, then refusing to deal with the monopolist is not likely to be a credible sanction for its opportunistic behavior. The ultimate social goal is to make such markets more competitive. Increased competition brings not only the standard benefits of lower prices and expanded output, but also gives buyers a credible threat to discipline opportunism by refusing to deal again with opportunistic suppliers. In theory, by disciplining contractual opportunism, the law can lessen the risk of dealing with new, unknown suppliers and thereby play an important role in facilitating entry into such markets. In practice, the absence of commercial norms in the initially monopolized market may limit quite severely a court's ability to discern and enforce transitional norms. Still, even a very limited judicial role in policing the most egregious and general forms of opportunism (instances approaching fraud, for instance) can play a socially valuable role by encouraging buyers to deal with new suppliers.

I thus believe that there are very strong theoretical reasons for thinking that the typical transactional dispute litigated under Article 2 of the Uniform Commercial Code emerges from a market and social structure that little resembles the world of the cotton industry explicated by Bernstein. At the present, however, this is merely a theoretical conjecture. Even if true, it does not detract from the enormous value of Bernstein's work. By getting the evidence first, and then developing a theoretical explanation, Bernstein's study not only advances our knowledge of private commercial lawmaking institutions, but provides a model for empirical legal scholarship more generally.