COPYING AND CONTEXT: TYING AS A SOLUTION TO THE LACK OF INTELLECTUAL PROPERTY PROTECTION OF CONTRACT TERMS

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In his Article *Contracts as Technology* Kevin Davis makes an analogy between technological innovation and contractual innovation and suggests that contractual innovation, like technological innovation, can both add value to exchange and promote trade. Davis presents a theory of the uses and sources of contractual innovation that has at its core the idea that "[t]he principal determinant of the value of adopting a contract is the value of the changes in behavior it induces."[1] The Article then draws on this theory and the analogy to technological innovation to explore the incentives of law firms, businesspeople, trade associations, and a variety of nonprofit institutions to engage in contractual innovation, even though there is no equivalent of copyright, trademark, or patent protection for contractual language. It concludes that given the lack of intellectual property protection for contractual language, potential contractual innovators of all types are likely to make socially sub-optimal investments in contractual innovation.

This Comment adds to Davis's analysis by describing the ways that standard-form contracts and trading rules are produced and used in trade associations. It suggests that many trade associations tie these contracts to other products and services they offer in ways that create contractual value for their members that is not fully available to those who might simply decide to adopt, or more aptly, copy the language of their contractual forms. As a result, association members endorse contract and trade rules revision efforts funded by membership dues even though these contracts can be copied and these rules incorporated by reference into transactions between nonmembers who in effect free ride on the associations' costly drafting efforts. More broadly, exploring contractual innovation in the trade association

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[1] Kevin E. Davis, *Contracts as Technology*, 88 N.Y.U. L. REV. 83, 90 (2013).

context suggests that once it is recognized that the value of a contract depends as much on the institutional and interpersonal context in which it is adopted, governed, performed, and enforced as it does on the specific words used, the lack of intellectual property protection for contractual language might be far less of a barrier to contractual innovation generally than Davis suggests.

Trade associations are, and traditionally have been, important sources of standard-form contracts—in the form of both traditional contracts and trading rules that can be incorporated into contracts by reference. At least as far back as the 1860s, many United States–based associations have provided standard-form contracts and sets of detailed trading rules to help promote and support the exchange of particular types of goods.[2] These contracts and rules were regularly revised in response to problems that arose, changes in technology, and other changes in market conditions. The process of adopting these changes was—and in the case of trading rules, continues to be—costly and time-consuming. Trade rules are revised by committees of both paid association executives and elected members of the group's governing board. Changes are researched and debated extensively. In most groups, rule changes must be approved by a majority of group members, making it important for the revisers to clearly articulate the reasons for the proposed change. Although changes in optional standard-form contracts do not typically require membership approval, in practice associations go to great lengths to adopt only those changes that will be widely accepted in the trade.

Some of the associations that create these rules and contracts make them freely available on the web (or, in earlier times, in public libraries). Others make an effort to keep them private (or, at a minimum, discourage their dissemination) by posting them in members-only parts of their website. In practice, however, most association-drafted contracts and rules become widely known and are commonly used and/or referenced by nonmember traders. Nevertheless, despite this widespread copying of contracts and free riding on the investment of their members, these groups continue to invest in revising these rules and contracts. The reason for this is simple: Although the language of these rules and contracts can easily be copied by nonmembers, the value created by consummating a transaction using these forms is much higher when the forms are used in transactions between association members than it is when they are used in

[2] For a description of the rules creation process in several industries that occurred between 1860 and 1920, see Lisa Bernstein, *The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study*, 66 U. CHI. L. REV. 76 (1999).

transactions between nonmembers. Put more generally, while nonmembers can contract using the same legally enforceable set of written terms as members by using the standard form contracts or referencing the group's trading rules, these agreements cannot replicate the member-specific adjudication, education, and enforcement mechanisms built into these agreements; the common understanding of rules and contracts fostered by the association's educational efforts; the flexible adjustments the association's adjudicative approach promotes; or the value created by the legally unenforceable set of implicit terms in these agreements that are cooperatively created and bonded in the shadow of the association's membership rules and information intermediary functions.

Adjudication: The associations that make these rules and contracts typically provide an arbitration system to resolve disputes arising under them. As a condition of membership, members must agree to submit all disputes with other members to the association's private legal system in lieu of going to court. These private legal systems are relatively inexpensive to access.[3] They permit but do not require parties to be represented by legal counsel, permit only limited discovery, and tend to render quick and predictable judgments. Together these factors make a threat to resort to third-party dispute resolution credible over a greater range of contracting values than it would be if an identical contract that could only be enforced in court were used, thereby increasing transactors' incentives to perform as promised.

The arbitrators who decide cases in these systems are drawn from the association membership and tend to be prominent industry members. They are familiar with the way business is done throughout the trade and are well versed in the meaning of trade rules and standard contract provisions. Nevertheless, the arbitrators in these tribunals typically employ a formalistic/textualist adjudicative approach. They do not look to courses of performance, courses of dealing, usages of trade, good faith, or the particulars of the contracting context to interpret agreements.[4] Arguments based on fairness, equity, or unique aspects of the contracting context are therefore generally unavailing. As a consequence, the adjudicative process in these private

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[3] For examples of filing fees from many associations, see Lisa Bernstein, *The NGFA Arbitration System at Work*, NAT'L AGRIC. L. CTR., 5 & n.11 (Mar. 15, 2007), http://nationalaglawcenter.org/assets/linkstorage/ngfa.pdf.

[4] *See* Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765 (1996) [hereinafter Bernstein, *Merchant Law*]; Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 U. MICH. L. REV. 1724, 1735–37 (2001) [hereinafter Bernstein, *Cotton Industry*].

systems is cheaper, faster, and more predictable than it is in the public court system. A contract between two association members that is subject to industry arbitration is therefore more valuable than an identical contract used by two nonmembers who have to bear the cost and unpredictability associated with going to court when a dispute requiring third-party adjudication arises.

Education: The associations that promulgate these rules and contracts also invest resources in educating members about the terms and meanings of these documents. This, too, operates as a tying mechanism. Seminars are held where traders study the rules, work hypotheticals, and take exams. One group even runs a summer school where new traders are taught the industry's rules and norms.[5] Associations also host web seminars, listservs, and other web-based programs to familiarize traders with both industry norms and the content and meaning of trade rules and standardized contracts. Trade publications contain discussions of the way rules work and often advise transactors to include particular provisions to achieve certain defined goals. Thus, when two traders who have received this education are doing business under association-drafted contracts or trade rules, they are likely to have a common understanding of what they are required to do, as well as an understanding of the ways that the industry-expert arbitrators are likely to decide a particular case. As a result of these relatively convergent expectations about both the contours of the expected performance and the outcome of potential disputes, member-to-member use of a standard-form contract should lead to both reduced disputing rates and increased settlement rates, as compared to situations where two nonmembers contract using the same form-contract. This common knowledge (combined with the membership rules and enforcement mechanisms discussed below) promotes the formation of cooperative contractual relationships between members and helps to ensure that, once established, these relationships endure, thereby adding value to these exchanges.[6]

Enforcement: The associations that create private legal systems also screen new members for commercial integrity, often requiring an existing member to guarantee their contractual obligations for a period of time. Arbitration opinions tend to be circulated widely and often contain descriptions of bad contracting behavior, even on the part

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5 *See* Bernstein, *Cotton Industry*, *supra* note 4, at 1727 n.16.

6 For a detailed discussion of the ways that a trade association's membership rules, private legal system attributes, social outreach, and information-intermediary functions can promote the creation and maintenance of cooperative contracting relationships, see generally Bernstein, *Cotton Industry*, *supra* note 4.

of parties who prevail under the rules. As a consequence, when members use these contracts with other members they are, in effect, also posting a reputation bond that gives these agreements more value than if the same written contracts were used with a nonmember. When an arbitration decision is rendered in these private systems, the losing party is very likely to comply with the judgment, as most groups both publicize non-compliance and expel non-complying members from the group, an act that tends to be widely publicized throughout the trade.[7] Although arbitral judgments can be attacked in court (albeit on the very narrow grounds permitted by the Federal Arbitration Act), in practice this is very rarely done. Disputants understand that going to court is a violation of industry norms of behavior and will become quickly known, damaging their reputation and making others less likely to deal with them. As a consequence, most arbitral judgments are complied with promptly. This, in turn, increases the value of these contracts when used between members as compared to the value they would have when used between nonmembers.

Extralegal Terms: As discussed above, association-created tribunals do not, for the most part, look to course of performance, course of dealing, usage of trade, or other context-based considerations in deciding cases. As a consequence, transactors can supplement the association-drafted standard-form contracts with value-creating extralegal terms (terms that can condition on information that is observable but not verifiable) backed only by reputation bonds and/or the threat of terminating a profitable repeat dealing transactional relationship. Because member-transactors are confident that association arbitrators, unlike courts, will not transform the extralegal terms of their agreements into legally enforceable contract provisions, members dealing with other members are able to enter into agreements that consist of the optimal mix of both these standard provisions and transaction-specific value-creating legally unenforceable terms that are backed only by nonlegal sanctions. These legally unenforceable provisions can add significant value to contractual relationships that cannot be replicated in transactions between nonmembers. Nonmembers typically lack access to the

[7] Many associations publicize expulsions in the trade press or member circulars, while others, like the diamond industry, go much further. When a diamond trader fails to promptly comply with an arbitration award, he is expelled from every diamond bourse in the world and a large picture of him, akin to a Wild West wanted poster, is posted at the entry to every bourse along with a warning not to do business with him. *See* Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 128, 156 (1992).

association-facilitated reputation and information networks that create the nonlegal sanctions that are needed to reliably bond these provisions, provisions that often condition on information that is observable but not verifiable. As a consequence, transactions between members that are governed by combinations of legal and extralegal terms will be systematically more valuable than transactions between nonmembers using the same standard-form contracts that must be enforced, if at all, in the public legal system.

Finally, because association tribunals do not look to courses of performance or courses of dealing, association members dealing with other members will be more likely to make flexible value-creating adjustments when the need for them arises; they will be able to do so safe in the knowledge that these adjustments will not erode their contractual rights in the future should a dispute requiring third-party adjudication arise.[8]

In sum, by tying members' use of their standard-form contracts and trading rules to a variety of association-provided benefits that are not available to nonmembers, associations ensure that the value created by their rules and contracts when used in transactions between members will always be higher than the value of their rules and contracts when used in transactions between nonmembers. Therefore, even when these rules and contracts are copied by nonmembers who free-ride on both the efforts of members and the association dues that are allocated to revise these rules and contracts, the value captured by members appears to be large enough to encourage contractual innovation, though whether or not it is at the fully optimal amount cannot be determined. The trade association case therefore illustrates a more general reason that contract drafting and innovation occurs despite the lack of intellectual property protection—namely, that the individuals, firms, and groups that fund such innovation often operate in social, institutional, and transactional contexts that give their innovations a higher value to them than others can appropriate, making continued investment in contractual innovation desirable despite their limited ability to prevent others from appropriating and using their linguistic innovations.

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[8] For examples of this type of value creation at work in the grain and feed context, see Bernstein, *Merchant Law*, *supra* note 4.