

COMMENTARY

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INTRODUCTION

Enforceable promises discourage lying, cheating, and stealing. Contracts that embody such promises shape institutions, distribute power, and organize markets. The Smith–King critique of elite empirical contracts scholarship reveals a field preoccupied with the first set of functions and barely interested in the second. I am loath to second-guess this view without empirical evidence of my own. Instead, I draw from it two sets of implications—one for the substantive study of contracts, the other for the relationship between contract theory and contract empiricism.

First, I suggest that organizational approaches enrich the study of public aspects of private contracts, such as their import for nonparties, their role in social ordering, and the political content of contracting practices. Second, I read Smith and King’s work as a useful reminder that the role of empirical study in contracts goes beyond elaborating a fixed set of received theories. Real contracts teem with big puzzles; it pays to search across disciplinary lines for ideas to solve them.

Part I of this Commentary highlights some of the important insights that predicate the authors’ turn to organizations. Their literature survey reveals both a narrow range of motivating theories and a surprisingly confined view of the empirical subject among contracts scholars. Smith and King seek to expand the field of inquiry; and their effort resonates beyond the theories they propose. In Part II, I sketch one context where organizational approaches might yield a payoff. My goal is not to apply a particular theory, but to use a case study to imagine how a Smith–King inspired literature might differ from the prevailing one. The over-the-counter derivatives industry makes a fitting case study because its standard contracts are drafted by a single organization and have an unusual modular structure. A focus on organizations can shed new light on the implications of this contract form for the drafter, the users, and the public. In Part III, I return to the

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relationship between contract theories and the study of contracts, and comment on some methodological implications of Smith and King's insights.

I. MORE THAN SEVEN

Gordon Smith and Brayden King's article comprises two distinct contributions: an empirical survey of elite contracts scholarship and a call to expand its theoretical remit.¹ I address these in turn.

The first surprise in the Smith–King survey is just how few scholars, especially those with legal training who publish in elite law reviews, invoke actual contracts in their work. Over half a century into Karl Llewellyn's veneration of contractual reality² and a decade into Lisa Bernstein's empirical challenge to Llewellyn,³ most law professors either predicate their conclusions on a stylized understanding of contract documents or skip contracts altogether in favor of contract doctrines and contracting practices. Although some writers implicitly draw on experience with real contracts, Smith and King's strict filter—they count only those articles that examine particular contracts—is a revealing proxy for the reality quotient in scholarship.⁴ Scholars disagree about the content of contractual reality and the extent to which it belongs in contract doctrine, but they seem to agree that contracts are one part of contractual reality not worth studying.

Second, the dearth of contract documents in the studies of ostensibly contractual relationships is especially puzzling. Stewart Macaulay's seminal “preliminary” work on noncontractual business relations⁵ left a nagging question: if businesspeople do in fact ignore written contracts, why do they pay so much to have them produced, and spend so much time getting them (sort of) right?⁶ Smith and King's results imply that Macaulay's work—and Llewellyn's and Bernstein's, despite disagreements among them—is still taken as a mandate to look beyond contracts to “real” business relations, leaving the contract puzzle to linger. Even studies of interpretation and dispute resolution appear to gloss over the material object of interpretation and dispute.⁷

1. See D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 ARIZ. L. REV. 1, 23 (2009).

2. See generally Karl N. Llewellyn, *The First Struggle to Unhorse Sales*, 52 HARV. L. REV. 873 (1939) (arguing that the law of sales must reflect commercial reality).

3. Lisa Bernstein, *The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study*, 66 U. CHI. L. REV. 710, 714 (1999) [hereinafter Bernstein, *Questionable Empirical Basis*]; see generally 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*].

4. See Lee Epstein & Gary King, *The Rules of Inference*, 69 U. CHI. L. REV. 1, 2 (2002) (defining qualitative and quantitative empirical legal study).

5. Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963).

6. See generally Claire A. Hill, *Why Contracts Are Written in “Legalese,”* 77 CHI.-KENT L. REV. 59 (2001) (theorizing complex contract production in a law firm).

7. See generally Bernstein, *Merchant Law*, *supra* note 3. But see Mark C. Weidemaier, *Disputing Boilerplate*, 82 TEMPLE L. REV. (forthcoming 2009) (a study of dispute resolution provisions in sovereign debt contracts).

Third, the way in which contracts appear in doctrinal debates is bound to be peculiar because, even where literal contract language is present, it is at least twice-removed from the contracting context: doctrine mediates judicial opinions, which in turn mediate contract fragments made relevant by a given dispute. This time-honored line of academic work still offers critical insights into the uses of contract, but the disputing lens can only reveal a relatively small fraction of these uses.

To be cautious, some of the survey results may be due to Smith and King's decision to focus on top law and social science journals. On the one hand, elite perspectives are both influential and revealing of the values in the scholarly community. On the other, they may come with their own peculiar distortions. Might top law journals publish fewer empirical studies of contracts than, for example, empirical studies of the Supreme Court's constitutional jurisprudence? Are established law journals more likely to have a relatively narrow view of empiricism,⁸ and more broadly, be less likely to innovate?⁹ Moreover, if such journals publish more articles by professors at elite schools, and if such professors are less likely to have drafted and negotiated contracts themselves, the journals may publish fewer studies of actual contracts. Testing these questions would require a different study and is unlikely to detract from the authors' core message.

So far, contracts appear as something of a doughnut hole: leading scholarship revolves around the contract without elaborating it as such. Against this background, the interest of economists and law-and-economists in the contract form looks radical. The insight that parties might write their contracts a certain way to obtain information or structure incentives lends itself directly to empirical study. The questions might be straightforward—e.g., do parties in fact put disciplining terms in their contracts, and do such terms in fact discipline?—but they offer a testable way to connect contract form with its economic function.

Smith and King's project is part of the next generation of scholarship that points to the need to broaden the inquiry further into the form and function of contracts.¹⁰ Contracts may well do everything economists say they do; but at the very least, they do a whole lot more.

The authors might be pleased—and justly so—if their lucid framing of the four organizational theories were to inspire a crop of studies to supplement or challenge the three dominant economic perspectives.¹¹ But if that were all, I might

8. Epstein & King, *supra* note 4, at 1–2.

9. Research on innovation in corporate law, for example, suggests that more established players are less likely to innovate. See generally Scott Baker & Kimberly D. Krawiec, *The Economics of Limited Liability: An Empirical Study of New York Law Firms*, 2005 U. ILL. L. REV. 107 (2005); Michael J. Powell, *Professional Innovation: Corporate Lawyers and Private Lawmaking*, 18 LAW. & SOC. INQUIRY 423 (1993).

10. ANNELISE RILES, COLLATERAL KNOWLEDGE: LEGAL REASON IN THE GLOBAL FINANCIAL MARKETS (forthcoming) (manuscript at ch. 2, on file with author); Smith & King, *supra* note 1, at 40; Mark C. Suchman, *The Contract as Social Artifact*, 37 LAW & SOC'Y REV. 91, 92 (2003).

11. Cf. Smith & King, *supra* note 1, at 23 (“We were pleased to find three articles motivated at least in part by the organizational theories discussed . . . below.”).

be a little disappointed: the article's contribution goes beyond growing the number of explanatory theories in the contracts repertoire. Some of Smith and King's most interesting insights are significant quite apart from the theoretical menu they propose. They expose persistent gaps in contracts scholarship, gaps that separate contracts, contracting, contracts doctrine, and contract theories. Describing contracts as products and charters of organizations offers a holistic alternative. It re-situates contracts as indispensable and multi-functional elements of social and political systems, which are in turn indispensable to the study of contracts.

I find Smith and King's call to pluralism particularly compelling because I have stumbled on debt contracts in my own work that seemed at once all-important as public symbols and near-irrelevant as instruments to achieve their stated private goals of deterring opportunism and establishing an orderly renegotiation procedure.¹² The fact that nonparties appropriated the debt contracts for their own purposes was intriguing, but hard to ground in established contract theories. Looking at the same incident from an organizational perspective takes the mystery out of nonparty interest: contracts are artifacts, resources, and public goods. That a nonparty might wish to appropriate a contract form or any other aspect of the contract seems natural, no less so than appropriating a tool or a slogan. The next task is to figure out the nonparty's motivations, and how its involvement might affect the contract, the parties, and the contracting practice.

II. PUBLIC PROMISES AND ORGANIZATIONAL AGENDAS

This Part imagines how Smith and King's view of contracts as organizational devices might help frame the study of the global over-the-counter (OTC) derivatives market, the institutional participants in this market, and the contracts that govern their interactions.

A. Other People's Contracts: A Crisis Story

In October 1998, Japan nationalized Long-Term Credit Bank (LTCB), once the ninth largest in the world.¹³ The fall of LTCB marked a critical turn in Japan's "lost decade." As bank failures accelerated, the authorities conceded for the first time that a financial crisis was afoot, and that it warranted a comprehensive response. But before they took over LTCB, Japanese officials turned to the International Swaps and Derivatives Association (ISDA), a private trade group with worldwide membership. The government wanted to be certain that the way it went about nationalizing LTCB did not trigger termination under ISDA agreements.¹⁴

12. See generally Anna Gelpern & Mitu Gulati, *Public Symbol in Private Contract: A Case Study*, 84 WASH. U. L. REV. 1627 (2006).

13. GILLIAN TETT, *SAVING THE SUN: HOW WALL STREET MAVERICKS SHOOK UP JAPAN'S FINANCIAL WORLD AND MADE BILLIONS* xxii, 115 (2004) ("LTCB is ranked ninth largest in the world by asset size, with a market capitalization several times that of Citibank."); Hiroshi Nakaso, *The Financial Crisis in Japan During the 1990s: How the Bank of Japan Responded and the Lessons Learnt* 12–13 (BIS Papers, Working Paper No. 6, Oct. 2001).

14. Nakaso, *supra* note 13 at 12–13.

ISDA's standard forms governed thousands of LTCB contracts worth at least \$450 billion.¹⁵ The government wanted those contracts to go on performing; however, the literal translation of its takeover authority ("special public administration") could be read as an event of default in ISDA forms—a trigger that gave counterparties an out. A rush of market participants closing out their LTCB positions could unleash large-scale selling of yen-denominated assets, push down the currency, push up interest rates, and disrupt already fragile markets. Working closely with ISDA, government officials decided to use different language ("temporary nationalization") to describe its actions. ISDA then publicly endorsed the approach with a statement on October 22, 1998—a private "no-action letter" of sorts—that preempted a rush for the exits.¹⁶

In this episode, a nongovernmental organization that produces, disseminates, interprets, and facilitates the enforcement of other people's contracts assumed a regulatory role. Just as government regulators work with market participants to interpret rules and create space for commercial activity, ISDA staff collaborated with officials to interpret its contract form to create space for public policy. The episode also highlights a public aspect of the contract itself. ISDA's boilerplate may have been perfectly suited for any given bilateral arrangement; however, the fact that it was replicated in synchronous arrangements throughout the financial markets—including "most of the major banks in the world"¹⁷—created negative externalities in the form of macroeconomic (here exchange rate and interest rate) pressures. On the other hand, centralizing interpretation authority in one governing body limited the spillover effects from the boilerplate it had helped diffuse.

Contracts scholarship does not usually deal with nonparties and other people's contracts. Mirroring contracts doctrine,¹⁸ most scholars address contracting parties, potential contracting parties,¹⁹ and judges dealing with parties. In contrast, the interesting questions from the LTCB incident go to the role and

15. DAVID ANDREWS ET AL., FITCH RATINGS, BANK SUPPORT IN THE DEVELOPED WORLD 14 (2002), available at http://www.fitchratingsasia.com/_uploadReport/3357202223132493.pdf; TETT, *supra* note 13, at 114–15; Nakaso, *supra* note 13 at 12–13. The figure represents notional principal outstanding. Notional figures may give a skewed impression of the size of the market, since the payment obligations exchanged are usually only a fraction of the notional amount used as the basis to calculate them.

16. ANDREWS ET AL., *supra* note 15, at 13–14; TETT, *supra* note 13, at 114–15; Nakaso, *supra* note 13, at 12. See also *Int'l Swap Traders' Group Satisfied with Japan's Help for LTCB*, JJI PRESS TICKER SERVICE, Oct. 22, 1998, available at LEXIS, News & Business, Individual Publications, JiJi Press Ticker Service.

17. TETT, *supra* note 13, at 114.

18. With reference to nonparties, the norm is embedded in doctrine—third party beneficiaries are narrowly defined. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS §§ 302(2), 315 (2008); see also *Martinez v. Socoma Cos.*, 521 P.2d 841, 843 (Cal. 1974) (rejecting class action challenge to government contracts brought by targeted but still "incidental" beneficiaries).

19. PATRICK BOLTON & MATHIAS DEWATRIPONT, CONTRACT THEORY 608–11, 642 (2005).

incentives of the nonparty drafter, nonjudicial interpreter, and nongovernmental enforcer.

B. Outward-Looking Contract Design

That private contracts have a public dimension is hardly novel. However, legal scholars tend to take a relatively narrow view of this dimension: contracts “become public” when courts side with one or another party, putting the power of the state behind its privately negotiated position.²⁰

Reality is richer. The organizational functions of contract in the Smith–King article highlight some of the more subtle public aspects of private promises. In the resource-based view (RBV), contracts secure competitive advantage. The objective of contract design, at least in part, is to shape the market in which contracting parties operate, not just—perhaps not even first—the relationship between them.²¹ Learning theories, already popular in the vast “boilerplate” literature,²² point to more public effects: contracts embody, disseminate, and entrench collective knowledge at the level of a single firm or a large population. Where contractual routines are pervasive, interdependent, and “sticky,”²³ they can result not only in suboptimal private arrangements (the focus of “stickiness” studies), but also in suboptimal market structures.²⁴ The capacity of contracts to shape and communicate group identity, and to express and maintain standards of legitimacy, reveals their importance in social ordering.

The market-structuring, knowledge-spreading, self-constituting, and standard-setting capacities of the contract form make it valuable for many actors outside the contracting relationship, provided they can find ways to deploy other people’s contracts to advance their own purposes, which may be instrumental or symbolic.²⁵ Conceived as an organizational device, the contract has more uses and a broader universe of potential users than is generally supposed. The next two Sections suggest how this insight might contribute to the study of derivatives contracts and the markets in which they operate.

20. See generally Daniela Caruso, *Contract Law and Distribution in the Age of Welfare Reform*, 49 ARIZ. L. REV. 665 (2007); Duncan Kennedy, *From the Will Theory to the Principle of Private Autonomy: Lon Fuller’s “Consideration and Form,”* 100 COLUM. L. REV. 94 (2000); Peer Zumbansen, *The Law of Society: Governance Through Contract*, 14 IND. J. GLOBAL LEGAL STUD. 191 (2007).

21. Compare Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799, 801–03 (1941) (discussing what Fuller calls the “channeling” function, also discussed in Kennedy, *supra* note 20, at 102–04), with Philippe Aghion & Patrick Bolton, *Contracts as a Barrier to Entry*, 77 AM. ECON. REV. 388 (1987).

22. E.g., Omri Ben-Shahar, *Foreword to “Boilerplate”: Foundations of Market Contracts Symposium*, 104 MICH. L. REV. 821 (2006); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or “The Economics of Boilerplate”)*, 83 VA. L. REV. 713 (1997).

23. E.g., Omri Ben-Shahar & John A. E. Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651 (2006).

24. Gelpern & Gulati, *supra* note 12, at 1651–52 (discussing the perceived need for government involvement due to market-wide contract inflexibility).

25. See *id.* at 1713–14.

C. Contract Makes Market

This Section describes ISDA, its contracts, its contract-drafting and related activities as subjects of an organizational inquiry. The next section sketches out potential avenues for analysis.

ISDA emerged in 1985 from a series of meetings among eighteen large financial intermediaries and four law firms, gathered to distill a common vocabulary for privately traded derivatives contracts.²⁶ When asked about the group's origins, lawyers in the industry volunteer apocryphal stories of the months it took to bring early contracts to fruition, and of legendary men taking the Concorde to attend lavish closings in London. Today's deals take seconds, in large part thanks to ISDA's standardization work.

When the Japanese government took over LTCB in October 1998, the global OTC derivatives market stood at \$72 trillion, as traditionally measured by the notional amounts outstanding.²⁷ By the summer of 2008, it had surpassed \$680 trillion.²⁸ In 1998, ISDA had over 360 members worldwide; at this writing they have more than 800.²⁹ Intermediaries, or dealers—large financial institutions, investment and, increasingly, commercial banks³⁰—remain the largest and most active constituency. However, in recent years the group has steadily expanded to end-users (for example, industrial companies hedging risk) and service providers, such as law firms and technology specialists. Despite, or in response to, early criticism of pro-dealer bias, the aspiration of universal membership has become entrenched.³¹ During the summer of 2008, ISDA had a staff of about seventy, most

26. ANTHONY C. GOOCH & LINDA B. KLEIN, *DOCUMENTATION FOR DERIVATIVES* 18–19 (4th ed. 2002); ALLEN & OVERY, *AN INTRODUCTION TO THE DOCUMENTATION OF OTC DERIVATIVES: “TEN THEMES”* 3 (May 2002), available at <http://www.isda.org/educat/pdf/ten-themes.pdf>. Kimberly Krawiec offers a pithy and useful definition of derivatives as “bilateral contract[s] or payment exchange agreement[s] whose value is linked to, or derived from, an underlying asset (such as a currency, commodity or stock), reference rate (such as the Treasury Rate, the Federal Funds Rate or LIBOR), or index (such as the S&P 500).” Kimberly D. Krawiec, *More than Just “New Financial Bingo”: A Risk-Based Approach to Understanding Derivatives*, 23 J. CORP. L. 1, 6 (1997). Derivatives fall into one of two categories: “those . . . that are standardized and actively traded on exchanges . . . and those that are customized for the specific needs of a particular investor.” *Id.* at 7. This Commentary focuses on the latter category—known as “over-the-counter (OTC) derivatives”—which are typically not exchange-traded, and not regulated. *Id.* at 7–8.

27. See Bank for Int'l Settlements, *Semiannual Amounts Outstanding of Over-the-Counter (OTC) Derivatives*, <http://www.bis.org/statistics/otcder/dt1920a.csv> (last visited Feb. 19, 2009) (CSV data, not html format).

28. Bank for Int'l Settlements, *Amounts Outstanding of Over-the-Counter (OTC) Derivatives*, <http://www.bis.org/statistics/otcder/dt1920a.pdf>.

29. About ISDA, http://www.isda.org/www/wwa_nav.html (last visited Feb. 4, 2009); A Retrospective of ISDA's Activities 1999, at 1–2, http://www.isda.org/www/Retrospective_1999_Master.pdf.

30. See generally Saule T. Omarova, *The Quiet Metamorphosis: How Financial Derivatives Changed the “Business of Banking”* (2009) (unpublished manuscript, on file with author).

31. As this issue went to press, ISDA added three nondealer members to its board for the first time. ISDA News Release, *ISDA Adds New Perspective to Its Board with*

of them in New York and London.³² Although the group has only a handful of legal staff, trained lawyers also work in its regulatory and tax departments. A significant part of the staff is dedicated to staging over a hundred conferences every year worldwide.

The group's first product was the *Code of Standard Wording, Assumptions and Provisions for Swaps* ("Swaps Code"), released in 1985. The Code—a compendium of terms—directly responded to industry demand for a "common vocabulary." A simple form contract for currency and interest-rate swaps followed in 1987.

Today's modular architecture of ISDA documentation emerged in the early 1990s.³³ A standard-form Master Agreement written to work under U.S. or English law was first released in 1992.³⁴ The Master is neither product- nor party-specific; it is designed as the fixed generic core of every trading relationship, which may last for ten to fifteen years.³⁵ It links to other, more tailored, modules by reference.³⁶ Prospective counterparties supplement this core with a Schedule, which addresses credit and legal risks specific to the contracting firms, but is not product-specific.³⁷ A Credit Support Annex governs collateral arrangements between the parties.³⁸ Definitions booklets, direct successors to the Swaps Code, are product-specific collections of standard terms promulgated by ISDA and incorporated by reference in individual transactions.³⁹ Short-form Confirmations set out the terms of individual transactions between specific parties; they incorporate the relevant Definitions by reference.⁴⁰ Long-form Confirmations are more elaborate; they are used between parties that have no Master in place, as well as for new products where ISDA is yet to promulgate definitions.⁴¹ Long-form Confirmations still incorporate standard ISDA terms by reference, but the result is customized to the transaction.⁴² User's Guides to ISDA documentation, true to their name, explain the contracts.⁴³

Three Buy-Side Representatives (Feb. 19, 2009), <http://www.isda.org/press/press021909bod.html>.

32. ISDA Staff Information, <http://isda.org/wwa/staff.html> (last visited Feb. 5, 2009). It also has offices in the District of Columbia, Brussels, Singapore, Hong Kong, and Tokyo. *Id.*

33. See, e.g., ALLEN & OVERY, *supra* note 26, at 2. Several lawyers involved in the early days of ISDA form design reported that this architecture was inspired by standard-form loan documents of the World Bank, a big and early end user.

34. *Id.*

35. See *id.* at 3.

36. See *id.*

37. See *id.*

38. See *id.* at 4–5.

39. See *id.* at 3–4.

40. *Id.* at 3.

41. *Id.*

42. See *id.*

43. See *id.* at 5.

A combination of Schedules, Annexes, and Confirmations effectively modifies the Master to fit particular parties and transactions.⁴⁴ Institutions adopt the framework voluntarily, and are free to vary any part.⁴⁵ Some institutions write their own masters and modules to suit their organizational or transactional needs.⁴⁶ However, even those that customize tend to retain the modular structure.⁴⁷

On occasion, the legal or economic landscape shifts enough to prompt market-wide amendment of the Master, though not enough to warrant its total overhaul.⁴⁸ ISDA's Protocols centralize the amendment procedure. The group puts forward new terms and invites members to accede to them by filing a letter with ISDA. When two firms have filed accession papers, the Protocol's amendments become binding between them.⁴⁹ This process is similar to treaty accession practice under public international law, where the United Nations commonly serves as the repository of state accession instruments.

This standard-form architecture is obviously different from the bespoke contract archetype that dominates first-year contracts textbooks. It also stands apart from the more "modern" images of contract boilerplate, either as pre-printed text with a few hand-inked "dickered terms," or as massive corporate tomes iterated from deal to deal with minor tweaks. In the OTC derivatives market, people entering into the economic deal do not simply gloss over small print legalese at closing; they may never see it at all. Their firms likely bound themselves to the contracting framework through separate institutional (usually legal) channels. Contracting is literally "disaggregated."⁵⁰

ISDA's contracts are the work of a documentation committee. At about 3000 people, it is by far the largest of the membership committees. But only a subset of committee members (usually representing dealers and the largest investors) participate actively in the drafting. The work is coordinated by ISDA staff, often with input from outside experts.⁵¹

Decisions to develop standard forms for new products, to amend existing forms, and to intervene in legislative or judicial matters are made by ISDA management in consultation with members and outside experts, often in response

44. See generally *id.*

45. See *id.* at 3.

46. See *id.*

47. See *id.* at 2.

48. ISDA promulgated a new Master Agreement in 2002. ISDA Master Agreements and Bridges, <http://www.isda.org/publications/isdamasteragmnt.html> (last visited Feb. 22, 2009). Many nondealers continue to use the 1992 version because they consider the new one too dealer-friendly. Lauren Teigland-Hunt & GuyLaine Charles, *The Evolution of Standardization in the OTC Derivatives Market*, MFA REP., Jan.–Feb. 2009, at 3.

49. See ALLEN & OVERY, *supra* note 26, at 6–7; ISDA 2002 Master Agreement Protocol (July 15, 2003), available at <http://www.isda.org/2002masterprot/docs/2002Protocol.doc>.

50. Choi and Gulati used the term as a metaphor. Stephen J. Choi & G. Mitu Gulati, *Contract as Statute*, 104 MICH. L. REV. 1129, 1172 (2006).

51. This is a typical production pattern for nonprofits. See Kevin E. Davis, *The Role of Nonprofits in the Production of Boilerplate*, 104 MICH. L. REV. 1075, 1081 (2006).

to member initiative. Information is disseminated among members; however, decision-making procedures appear to be informal—consultation and consensus prevail over ballots and ceremony. According to staff and outside lawyers involved in the drafting process, the group has traditionally waited for the market to gain experience with a product before reducing it to a standard form. In recent years, members have increasingly turned to ISDA for documentation soon after a product has been launched.

ISDA copyrights its documentation⁵² and derives revenue from it. Several industry lawyers have described the copyright-holding function as a central justification for ISDA's existence. The drafting monopoly in turn gives ISDA voice in the interpretation and enforcement of its contracts worldwide, and ultimately, political power—most apparent in its influence over financial market regulation.⁵³

ISDA has sought favorable legal, regulatory, and judicial treatment for its contracts.⁵⁴ It has worked to exempt them from oversight by securities and commodities market regulators,⁵⁵ and has succeeded in shielding them from public interference in bankruptcy. Derivatives contracts are generally⁵⁶ exempt from the bankruptcy stay on creditor enforcement and fraudulent conveyance rules, among others.⁵⁷ While all other contracts remain frozen, the exemption lets counterparties under derivatives contracts net aggregate exposure to the insolvent firm, presumably protecting the markets at the expense of the bankruptcy estate. Because bankruptcy and secured credit laws cannot be fully disclaimed by

52. ISDA Publications, Frequently Asked Questions on Copyright, <http://www.isda.org/publications/pdf/FAQs-on-Copyright.pdf> (last visited Feb. 5, 2009).

53. Frank Partnoy refers to something like this effect as a “second-order benefit” from ISDA's status as a standard-setter in the OTC derivatives industry. Frank Partnoy, *Second-Order Benefits from Standards*, 48 B.C. L. REV. 169, 171, 187–89 (2007). However, he focuses on second-order benefits to ISDA's membership, for example, in the form of preferential access to information. My interest is in benefits to ISDA.

54. See, e.g., FRANK PARTNOY, *INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS* 152–54 (2004).

55. See, e.g., *Commodity Futures Modernization Act of 2000*, Pub. L. No. 106-554, 114 Stat. 2763 (codified as amended in scattered sections of 7 U.S.C.); PRESIDENT'S WORKING GROUP ON FIN. MKTS., *HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT* (1999), available at <http://www.ustreas.gov/press/releases/reports/hedgfund.pdf>; Frank Partnoy, *ISDA, NASD, CFMA, and SDNY: The Four Horsemen of Derivatives Regulation?*, in *BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES* 213 (Robert E. Litan & Richard Herring eds., 2002).

56. In 2005, the U.S. Bankruptcy Code was revised to expand the universe of exempted contracts, constrain judicial discretion and encourage judicial deference to industry views. Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641, 641–44 (2005); see also Stephen J. Lubben, *Credit Derivatives and the Future of Chapter 11*, 81 AM. BANKR. L.J. 405 (2007).

57. This prevents the trustee from collecting on contracts where the estate stands to gain, while repudiating payment obligations to the same counterparties. See generally *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11 U.S.C.).

contract, ISDA has sought clarifications and changes in the law to permit bankruptcy netting in multiple jurisdictions, and it has obtained legal opinions from local counsel in over forty countries attesting to the enforceability of netting provisions in their contracts.⁵⁸ Only members may rely on these opinions.

ISDA's amicus brief practice grows out of its contract drafting work. Most of its interventions are in regulatory and bankruptcy settings, where the group has essentially reiterated its positions against regulation and for netting, siding with members against regulators and trustees.⁵⁹ ISDA's interventions in basic contract disputes are relatively rare, partly because it is loath to come in against members, even as its membership becomes close to universal. When it does participate, ISDA has tended to favor strict textualist interpretation. Its litigation posture and legislative strategy alike seek to minimize the scope for judicial discretion and functional analysis; the role of the courts in this view is to give effect to ISDA contracts as authoritative "codification"⁶⁰ of market practice.

ISDA has been increasingly active in developing procedures, such as auctions, to facilitate orderly settlement in the market where a major counterparty, ranging from Lehman Brothers to the Republic of Ecuador, is in distress.⁶¹ This role follows naturally from its drafting and legislative posture (implementing netting). It also extends ISDA's remit beyond interpretation, which drove the LTCB incident, into more structural aspects of the derivatives market.

The next Section revisits this landscape using Smith and King's organizational insights.

D. Organizational Agendas

Contracts scholars often ask what trade groups do for contracts—how they improve drafting,⁶² respond to legal shocks,⁶³ and resolve interpretation

58. Annelise Riles, *The Transnational Appeal of Formalism: The Case of Japan's Netting Law 20 & n.91* (Stanford/Yale Junior Faculty Forum, Research Paper No. 00-03, 2000), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=162588; ISDA, Status of Netting Legislation, http://www.isda.org/docproj/stat_of_net_leg.html (last visited Feb. 5, 2009).

59. See ISDA, Legal Resources—Amicus Briefs, <http://www.isda.org/> (last visited Feb. 19, 2009).

60. Brief for International Swaps and Derivatives Association, as Amicus Curiae Supporting Defendant-Appellant at 4–5, *AON Fin. Prods., Inc. v. Société Générale*, 476 F.3d 90 (2d Cir. 2007) (No. 06-1080-CV), available at www.isda.org/speeches/pdf/ISDA-Amicus-Curiae-Brief05-08-06.pdf.

61. See, e.g., ISDA, PLAIN ENGLISH SUMMARY OF THE AUCTION METHODOLOGY IN THE 2009 ECUADOR CDS PROTOCOL, available at <http://www.isda.org/2009ecuadorcdsprot/docs/Ecuador-Plain-English-Summary.pdf>; ISDA, Press Release, Success of ISDA Protocol Series Continues, ISDA Launches Washington Mutual Protocol (Oct. 16, 2008), available at <http://www.isda.org/press/press101608.html>.

62. See Davis, *supra* note 51, *passim* (arguing among other advantages that nonprofits have a cost advantage at preparing and disseminating contract boilerplate, and may produce more even-handed terms).

63. See Choi & Gulati, *supra* note 50, at 1158–59 (citing ISDA's quasi-legislative response to a federal court's interpretation of its restructuring credit event in

disputes.⁶⁴ Reflecting back on the role that contracts play in constituting and motivating industry groups is different. This line of inquiry goes to group incentives, decision-making, legitimacy, and authority, and in turn helps contextualize the form and content of the contract. Without it, a judge or policy maker who turns to an industry group for insight to interpret or regulate has only partial information to guide her deference.⁶⁵

Deference to trade usage, real or imagined, is embedded in contract law.⁶⁶ Courts and scholars—even scholars who doubt the wisdom of court recourse to trade usage—traditionally treat trade groups as repositories of trade usage. Recent scholarship highlights two aspects of trade group involvement in contract practice. First, new formalists⁶⁷ ask whether businesspeople that operate in norm-rich communities prefer public courts to discover and apply community norms, or to enforce their contracts as written.⁶⁸ This scholarship addresses the existence and role of norms in commercial relationships. A more recent crop of studies appraises welfare gains from having third parties, especially nonprofits, draft standard-form contracts for the broader markets. The verdict is positive: in addition to aggregating and disseminating trade norms, groups can offer economies of scale, promote learning, overcome stickiness, and, especially where they have broad membership, reduce the scope for advantage-taking.⁶⁹

There is no reason to doubt that group involvement has all of the above and other advantages. It is equally plausible and not at all contradictory to suppose

Eternity Global Master Fund Ltd. v. Morgan Guaranty Trust Co. of N.Y. & J.P. Morgan Chase Bank, 375 F.3d 168 (2d Cir. 2004)).

64. See generally Bernstein, *Merchant Law*, *supra* note 3 (discussing contract interpretation by private industry tribunals).

65. Questions of group motive/incentives have been raised in other settings, for example, in studies of interest group litigation. See, e.g., Lee Epstein, *Courts and Interest Groups*, in *THE AMERICAN COURTS: A CRITICAL ASSESSMENT* 335, 363 (John B. Gates & Charles A. Johnson eds., 1991); Suzanne B. Goldberg, *Intersectionality in Theory and Practice*, in *INTERSECTIONALITY AND BEYOND: LAW, POWER AND THE POLITICS OF LOCATION* 124, 144 (Emily Grabham et al. eds., 2009).

66. UCC section 1-103(a)(2) (2007) states that the purpose of the Act is “to permit the continued expansion of commercial practices through custom, usage, and agreement of the parties.” Other sections of the Code share this emphasis on the import of trade. See, e.g., § 1-303(c)–(e). Scholars have challenged the Code’s incorporation of trade usage, arguing among other things that uniform usage does not exist, or cannot or should not be determined by the courts. See, e.g., Bernstein, *Merchant Law*, *supra* note 3; Bernstein, *Questionable Empirical Basis*, *supra* note 3; Richard Craswell, *Do Trade Customs Exist?*, in *THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW* 118 (Jody S. Kraus & Steven D. Walt eds., 2000).

67. Richard H. Pildes, *Forms of Formalism*, 66 U. CHI. L. REV. 607, 619–21 (1999).

68. See generally Bernstein, *Merchant Law*, *supra* note 3; Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541 (2003).

69. Organizations whose members include both sides of a transaction produce more even-handed forms to please the membership as a whole. Davis, *supra* note 51, at 1085–88.

that trade groups have private objectives apart from the welfare of their members and the health of their markets, and that these objectives (which need not be devious) might influence the groups' work with contracts.

This relative reluctance of contracts literature to delve into group motivations does not stem from innocence. For example, when comparing form contracts to statutes, and trade groups to legislatures, Stephen Choi and Mitu Gulati acknowledge the possibility that some groups may be problematic—unrepresentative, wayward, or just plain sloppy.⁷⁰ Similarly, in his assessment of nonprofits' role in contract drafting, Kevin Davis allows for unrepresentative groups and conflict among groups.⁷¹ But the goal in both projects is to isolate the potential role of an ideal group type in contract practice,⁷² not to examine the role of contracts in the operation of real groups. The fact that Choi and Gulati, writing about ISDA, appear to take its broad membership, longevity, and market share as *prima facie* evidence of legitimacy is tangential to their argument. The right sort of group can testify to the original public meaning of a contract; ISDA looks good, but is not indispensable. Similarly, Davis's working assumption that nonprofits' contract practice follows their stated missions is there to highlight the gap between generic nonprofits and others, not as an empirical assertion about how any given nonprofit reconciles its institutional goals with those of its members.

Smith and King's organizational approach invites a flipping of the lens. The question becomes: how do ISDA-drafted contracts—their modular form, the process of their production, the way in which courts interpret them, and the degree of variation or customization in the market—relate to ISDA's organizational objectives? And how do the form contract infrastructure and the institutional landscape dominated by ISDA impact the contracting parties' organizational arrangements? The following are a few of the possible research questions that might follow from this shift in focus.

1. What are the implications of modular contracts and centralized drafting for the OTC derivatives market and for ISDA?

The modular, trans-jurisdictional, and cross-product design of ISDA's contracts has brought a large number of long-term relationships among financial firms worldwide under its documentation umbrella. This has both positive and negative externalities. On the one hand, the market may benefit from having a single predictable regime to govern many complex, specialized contracts. Moreover, in a netting world, it is hard to find a principled reason to exempt some financial contracts but not others from bilateral closeout arrangements. On the other hand, the push to fit more products under one roof for the sake of

70. Choi & Gulati, *supra* note 50, *passim*. Their response is to privilege the groups' quasi-public drafting history in judicial contract interpretation. A historical approach requires groups to formalize the process that results in a new interpretation. *Id.* at 55.

71. Davis, *supra* note 51, at 1088–89.

72. The role would likely be usage aggregators for Choi & Gulati, *see generally* Choi & Gulati, *supra* note 50, and nonprofits for Davis, *see generally* Davis, *supra* note 51.

organizational efficiency or market share may obscure real economic differences.⁷³ Physical disaggregation of contracting, discussed more below, potentially separates the people who understand the economics of a financial product from those who understand its legal structure; it creates new sources of risk that need to be managed.

In addition, even nimble organizations can become path dependent, while organizations with diverse memberships can become paralyzed by internal conflicts. Whether trade group inertia is less frequent or less problematic than coordination failures in atomistic contracting is an open question that can be tested. From a policy perspective, documenting a wide range of diverse financial products as swaps may limit the reach of formal regulation⁷⁴ and may create a parallel bankruptcy system for financial *firms*, not just a subset of financial *products*, with implications for global financial stability. The LTCB incident illustrates the potential.

2. *What is the relationship between contract interpretation strategies and governance in the business community?*

Derivatives trading is rife with informality.⁷⁵ Parties' business practices routinely depart from their contracts for business, tax, regulatory, and any number of other reasons. Yet ISDA's legislative and litigation posture has steadfastly discouraged functional and contextual analysis of its contracts by judges. This may be justified by financial complexity (polite proxy for judicial ineptitude).⁷⁶ But in such cases textualism also serves an independent governance function: it asks the court to fix and police the outer boundary of private regulation, not to interfere in its substance, which remains in ISDA's domain. Two implications follow. First, when courts choose interpretation strategies in financial contract disputes, they are allocating power between the public and private spheres, and within the private sphere. Second, a court's choice of textualism in deference to trade group amici implies a view of their governance role—not just their technical expertise. Under the circumstances, a court may pursue an administrative-style inquiry into the group's representative character, internal processes, and other factors affecting legitimacy, including novel ones, such as the extent of competition among private

73. See generally Michael Simkovic, *Secret Liens and the Financial Crisis of 2008* (Jan. 4, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1323190 (observing that market participants document a wide range of economic arrangements as swaps to take advantage of their favorable treatment in bankruptcy).

74. See Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641, 641–42 (2005).

75. See generally *Deutsche Bank AG v. AMBAC Credit Prods.*, No. 04 Civ. 5594, 2006 WL 1867497, at *12–14 (S.D.N.Y. 2006) (considering evidence of informality in the settlement of derivatives transactions); Alex Raskolnikov, *The Cost of Norms: Tax Effects of Tacit Understandings*, 74 U. CHI. L. REV. 601, 623–25 (2007).

76. Choi & Gulati, *supra* note 50, at 1130–33; Morrison & Riegel, *supra* note 74, at 643–44. Cf. Bernstein, *Merchant Courts*, *supra* note 3; David Charny, *The New Formalism in Contract*, 66 U. CHI. L. REV. 842, 848 (1999) (examining the relationship between formalism and judicial expertise); Craswell, *supra* note 66.

standard setters.⁷⁷ This may partly displace traditional inquiries into the particular intent of the contracting parties or the optimal design of incentives in a given business context.⁷⁸

3. *How does the architecture of a form contract affect the contract user's organization?*

The modular form of ISDA's contracts may reinforce specialization in financial firms. Traders may never see the legal terms of a Master Agreement; however, they alone may see transaction confirmations, which incorporate the Master by reference. Lawyers may have only limited exposure to the economic terms. This compartmentalizes knowledge. The old parable of people groping different parts of an elephant in a dark room illustrates the risk: absent measures to the contrary, few within the user organization may have a view of the entire contractual arrangement, or have the capacity to respond to shocks. Compartmentalization can increase the cost of drafting mistakes: for example, putting relationship-relevant terms into a confirmation, or deal-relevant terms into the Master, risks having these terms overlooked and may render them ineffective. An organization must devise procedures to address the risks that arise from using modular contracts.

In sum, ISDA's contract structures, as well as its predilection for formalism, are obviously successful and eminently rational—especially in a rapidly growing market. However, they also have consequences for the structure and politics of the marketplace. Treating the contract-drafting organization as a black box risks missing important costs and benefits of its involvement. Traditional public choice analysis⁷⁹ can go a long way to explain ISDA's positions and shed light on contracting practices among sophisticated business people⁸⁰ in the OTC derivatives world. But organizational theories, along with sociological⁸¹ and anthropological⁸² theories about knowledge, identify the subject of ISDA contracts as public in the first place.

III. CONTRACT THEORY AND CONTRACT EMPIRICISM

The previous Part imagined OTC derivatives contracts as a field for organizational study. This Part briefly returns to empirical methodology. Smith and King's literature survey suggests that today's empirical contracts scholars engage in a series of statistical up-or-down tests of narrow theoretical propositions, drawn from a limited number of economic theories. This approach is in contrast to famous qualitative studies noted earlier, including those by Macaulay, who went out to see if his contracts textbook had any relevance in the business world, and

77. Cf. David V. Snyder, *Private Lawmaking*, 64 OHIO ST. L.J. 371, 446 (2003) (addressing the role of competition in private lawmaking).

78. Cf. Choi & Gulati, *supra* note 50, at 1131 (proposing an alternative contract interpretation strategy).

79. See Robert E. Scott, *The Politics of Article 9*, 80 VA. L. REV. 1783, 1805–06 (1994) (using public choice to explain UCC politics).

80. See Schwartz & Scott, *supra* note 68, at 544.

81. See generally Suchman, *supra* note 10.

82. See generally RILES, *supra* note 10.

found out that it had little to none. More recently, Bernstein went out in search of Llewellyn's custom among diamond, cotton, and grain merchants, and found a contracting universe quite different from the UCC predicate. It is true and significant that many of the qualitative scholars have deliberately avoided contracts; the point was to find out what else determines business relationships.

But the resulting empirical contracts literature looks odd: comprising statistical studies of *contracts* and qualitative studies of *relationships*, substantively and methodologically apart.

Because Smith and King's organizational approach is at once cognizant of actual contracts and of their thick social setting, it is well placed to bridge the gaps between quantitative and qualitative, contracts and contracting studies. For example, it is difficult to see how one might discern the role of contracts in organizations without asking the people involved in the production and use of the contracts what it all means to them. Their answers may be misleading and self-serving—but the fact that informants would care enough to mislead is revealing, as is the way in which they do. Research questions of the sort raised in Part II of this Commentary lend themselves naturally to case studies and thick description, at least to supplement, if not partially displace, statistical analysis.

Qualitative inquiry might reveal diverse economic arrangements behind a single legal form, organizations' motives for getting involved in disputes and adopting certain interpretation strategies over others, and how such strategies are received in different parts of the market. Ethnographies of the documentation setting⁸³ are especially helpful because they shed light on the full complex of social structures, artifacts, and individual incentives as framed by these structures. On the other hand, statistical studies may test how well traders as a group understand the legal framework of their transactions, and may offer insight on compartmentalization of knowledge.

At the risk of reading too much into the organizational agenda, I see it pointing to a substantive and methodological pluralism that still holds the potential of producing disciplined theoretical and empirical contributions.

CONCLUSION

The mainstream “constitutional” view of contracts has them as vehicles for power dispersion.⁸⁴ This conclusion is intuitive where contracting is dispersed: private parties compete⁸⁵ in creating private law. Contract doctrine may check power disparities at the edges,⁸⁶ but it leaves the essential premise unchallenged—perhaps even reinforced. An organizational approach has the potential to change the calculus.

83. See, e.g., Annelise Riles, *The Anti-Network: Private Global Governance, Legal Knowledge, and the Legitimacy of the State*, 56 AM. J. COMP. L. 605 (2008); RILES, *supra* note 10.

84. Harry W. Jones, *The Jurisprudence of Contracts*, 44 U. CIN. L. REV 43, 50–54 (1975).

85. Snyder, *supra* note 77, at 374.

86. Doctrines ranging from (old) consideration to (new) unconscionability perform this function.

Asking what contracts do for organizations puts the organizations' agendas at the center of empirical inquiry. It invites the study of the political economy of contracts, the role of contracts in social ordering, and the production of knowledge. Knowing this role and the much broader social, cultural, and political significance of contracts should in turn inform their regulation and adjudication. To the extent anyone had ever looked at contracts solely as bilateral anti-cheating devices, that view is increasingly hard to sustain.

The relationship between contracts and contract-drafting trade associations is a case in point. In the traditional view, trade associations channel their membership's contracting druthers. An organizational study might ask how a given contract form might benefit the trade group, how the group's own preferences might affect the contract, and how the contract might in turn shape the contracting organizations.

At about the time that the Japanese government officials worked on the LTCB takeover with ISDA staff, David Charny wrote in a comment on Lisa Bernstein's article, that "[t]he work of the trade associations might best be understood as an attempt to accelerate—or to substitute for—the more spontaneous development" of business custom.⁸⁷ He went on to link the contract work of trade groups with the work of other private standard setters, which "points to substantial reason to fear rent-seeking behavior and sheer irrationality or arbitrariness" on the part of the standard setters, who often have considerable power to discipline their own.⁸⁸ Foreshadowing the more recent scholarship on "bottom-up" private lawmaking,⁸⁹ he observed rather darkly:

When one considers the elaborate apparatus by which the trade associations formulate and enforce customs . . . one is reminded of nothing so much as of Foucault's image of modern disciplinary institutions, which continuously survey and monitor their members and subject them to routines of training and discipline. . . . We are at this point quite far from the world of Llewellyn and Hayek, in which the immanent practices of business persons arise inductively as they generalize from their own day-to-day experience with transactions in the market. Instead, the customs come top-down, dictated by a bureaucratic apparatus centered on a private legislative body with national scope.⁹⁰

Ten years later, theory and practice have come full circle. Thanks to ISDA's standardization work, the derivatives markets have exploded. Thanks to ISDA's settlement infrastructure, these markets have continued to function amid

87. Charny, *supra* note 76, at 845 (emphasis added).

88. *Id.* at 856.

89. See generally Janet Koven Levit, *Bottom-Up Lawmaking: The Private Origins of Transnational Law*, 15 *IND. J. GLOBAL LEGAL STUD.* 49 (2008); Snyder, *supra* note 77.

90. Charny, *supra* note 76, at 856–57.

the broader financial collapse.⁹¹ Along the way, contracts—particularly sophisticated financial boilerplate—have acquired a statutory quality, abstracted from the contracting parties and barely accessible to their public regulators.⁹² And the organization that drafts them has once again become an indispensable partner for governments seeking their way out of a crisis.

Then and now, regulating and judging financial contracts requires an understanding of their public purpose and the organizational agendas that drive them. It is no longer plausible to know contracts without knowing the “bureaucratic apparatus” that produced them. Knowing the apparatus takes fieldwork. If Smith and King are right about the state of contract empiricism, the organizational inquiry they propose will considerably expand its scope.

91. *Role of Credit Derivatives in the U.S. Economy: Hearing Before the H. Comm. on Agriculture*, 110th Cong. (2008) (statement of Robert Pickel, Chief Executive Officer, ISDA), available at <http://agriculture.house.gov/testimony/110/h81208/Pickel.pdf>.

92. See generally Choi & Gulati, *supra* note 50.