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2007

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Juliet P. Kostritsky

Case Western University School of Law, juliet.kostritsky@case.edu

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Plain Meaning vs. Broad Interpretation: How the Risk of Opportunism Defeats a Unitary Default Rule For Interpretation¹

Juliet P. Kostritsky²

WITHOUT interpretation many contracts would remain uncertain of meaning and incapable of enforcement. Courts interpreting contracts must grapple with what the words of a contract mean as well as how to make that determination.³ These questions are likely to be troubling when the plaintiff and defendant have dueling interpretations of the meaning of a contract's terms.⁴

The problem of contract interpretation presents courts with significant questions about the nature and methodology of judicial intervention into private arrangements. The court often assumes an active role in interpreting the words of a written contract⁵ in part because words have more than one meaning or because a contract is incomplete.⁶ When a court chooses amongst variable meanings, or interprets contracts to craft limitations on parties' behavior when express limits do not exist, its choice must be justified using a justificative framework explored below.

Traditionally, commentators have advocated one of two general approaches to supply the methodology to govern judicial choices of contract meaning.⁷ The first restricts interpretation to the words used in

1 This article was selected by the Program Committee of the American Law and Economics Association for presentation at the annual meeting of the American Law and Economics Association that was held May 5 and 6, 2007 at Harvard Law School and presented on May 6, 2007.

2 John Homer Kapp Professor of Law, Case Western Reserve University School of Law. I am grateful for helpful comments from Professors Ronald J. Coffey, Peter M. Gerhart and Avery Katz. I am grateful for the research assistance provided by Michael Dory (J.D. University of Chicago Law School 2007).

3 Judges or juries or arbitrators make these determinations. See Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1582 (2005). Interpretation must precede any judicial determination of whether a breach has occurred and what performance is due under the terms of the contract.

4 Of course without "a real uncertainty about meaning, the challenge [of plaintiff or defendant] will present no interesting question of interpretation." *Id.*

5 Steven Shavell, *On the Writing and the Interpretation of Contracts*, 22 J.L. ECON. & ORG. 289, 290 (2005).

6 See *infra* note 42.

7 These approaches assume that the difference in meaning has not prevented contract formation. If the variability is too great and there is no way for a court to choose, it may find

the contract and the other accepts extrinsic evidence about what one or both of the parties to the contract intended that the words would mean or objective evidence of the meaning supplied by context⁸ or evidence of how ordinary commercial parties in a trade used the term or behaved in the current contract.⁹

This article argues that it is wrong to think that courts must make a dichotomous choice always to prefer extrinsic evidence or always to exclude it.¹⁰ Sometimes the appropriate interpretive methodology should explicitly forego extrinsic evidence while at other times it should embrace extrinsic evidence. The choice between the two methodologies should depend upon an assessment in each case about which interpretive methodology is most likely to (1) curb opportunistic behavior; and (2) implement the parties' actual intentions and overall goals,¹¹ in a cost-effective way to maximize gains from trade.¹²

The drive to curb opportunism under conditions of bounded rationality has been the focus of much of the work in new institutional economics

no contract. *See infra* note 39.

8 *See supra* note 3.

9 The primary proponents of this broader approach were Corbin and Traynor. Avery Katz, *The Economics of Form and Substance in Contract Interpretation*, 104 COLUM. L. REV. 496, 501 (2004).

10 The dichotomous approach may be thought of more flexibly when thought of "in probabilistic terms" (with some regimes more willing to admit a broader base of context evidence and other regimes less likely to do so). *Id.* at 517.

Professor Avery Katz similarly rejects the dichotomous choice and suggests that the choice of interpretation for parties will depend on matters such as the degree of risk averseness of the parties (with more risk averse parties favoring substantive interpretation since that approach reduces risk of improper interpretation), the transaction costs both *ex ante* and *ex post* (with formality being preferred where circumstances require quick decision-making), effect of interpretation on performance incentives (with direction being paid to inefficient precautions from erroneous interpretation), effect of *ex post* renegotiation costs (with formality dominating when parties can renegotiate at low cost to achieve efficient results), presence of reliance-based transaction-specific investments (with substantive interpretation being preferred where it can reduce the risk of hold up following investment), the relative presence of rent-seeking at the *ex ante* and *ex post* stage of contracting (with formality being preferred where rent seeking *ex post* likely and vice versa), the presence of "small and infrequent traders" (with substantive interpretation being preferred due to the inability to recoup the upfront "fixed" cost of negotiation over a large number of transactions), and the robustness of internal sanctioning networks. *Id.* at 525-36.

11 In some cases actual intentions may not exist and the court will then look to the parties' overall goals, including joint wealth maximization.

12 Courts seeking an interpretive methodology should strive to save parties drafting costs while not increasing enforcement costs by an amount in the excess of the amount saved in drafting costs. *See* Posner, *supra* note 3, at 1583 (explaining that "[b]ecause methods for reducing contractual transaction costs, such as litigation, are themselves costly, careful tradeoffs are required").

on rationalizing governance structures.¹³ These works seek to explain the “organizational imperative” to control opportunism in a cost-effective way, particularly where specific asset investment makes a simple exit from a contract relationship costly.¹⁴ This paper presents an analytical framework for choosing an interpretive methodology that can curb opportunism and implement the parties’ goals to maximize joint gains. It is associated with the law and economics branch of contract theory and thus seeks interpretive rules that will maximize¹⁵ *ex ante* efficiency. However, it posits that to achieve those goals and efficiency, courts must do more than promote standardization through giving judicial approval of a predefined set of “contractual signals for future parties”¹⁶ through law-supplied default terms and interpret terms to recognize private efforts to trump the state-supplied terms “when necessary to avoid an ill-fitting [state] formulation.”¹⁷ Courts must be willing to actively interpret contracts to curb opportunism even if it does not result in a stock of standardized terms that all parties can use in future contracts.

Of course, the parties are always free to choose the interpretive methodology that a court should use to interpret the contract.¹⁸ That choice might seem to obviate the need for a methodology to guide courts. Parties could, for example, control the interpretive process in part by limiting interpretation to the actual words of the contract, including a merger clause that would theoretically restrict the court’s role to the written document.¹⁹ This does not solve the interpretive problem, however. The parties often do not so specify, in which case courts must adopt an interpretive methodology that not only supplies that term but also appreciates the fact that the parties failed to do so. Moreover, even when the parties supply an interpretive methodology, perhaps by including a merger clause that restricts extrinsic evidence,²⁰ that provision must itself be interpreted and

13 See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM FIRMS, MARKETS AND RELATIONAL CONTRACTING* 32 (1985).

14 *Id.*

15 Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 NW. U. L. REV. 847, 849 (2000).

16 *Id.*

17 Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interaction Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 281 (1985).

18 Professor Avery Katz focuses on these types of parties’ private choices in interpretive methodology and proposes a “taxonomy of economic considerations” that will affect parties’ choices between a more formal and more substantive method. Katz, *supra* note 9, at 500.

19 *Id.* at 519.

20 This clause indicates to courts that a contract is completely integrated. If the court accepts that proposition, the merger clause will bar the admissibility of any extrinsic evidence, whether to supplement or to contradict the written contract. See E.A. FARNSWORTH, *CONTRACTS* § 7.3 (4th ed., 2004).

there are often exceptions that are crafted by courts, providing an occasion for judicial interpretation.

Whether a court is interpreting the words of the contract or the interpretive directions of the parties or filling a gap in a contract, the methodology the court uses should not be artificially separated from a normative theory that will identify interpretations that will be value maximizing for the parties. Nor can a court isolate the interpretive question from the context of the problems that the contractual language was crafted to solve or the transaction costs associated with crafting solutions to those problems.²¹ The interpretive process must therefore start by understanding the normative justification for any judicial intervention in private arrangements, paying attention to the bargaining problems that parties face, including the costs of anticipating future contingencies and future behaviors, the potential gains from effectively controlling opportunism (and the deadweight loss from failing to control it),²² while minimizing the costs of doing so, including the likely error and litigation costs from particular interpretive approaches in particular types of contexts dealing with parties' various problems.

The role of courts in contract cases is to preserve the autonomy of the parties by preserving the bargain they negotiated and maximizing the returns from the bargain. If, however, a contract is incomplete in ways that will be explored in this article, the court will have to judge, using an appropriate interpretive methodology, how to minimize occasions for opportunism by the parties²³ while simultaneously minimizing drafting costs for the parties and enforcement costs.²⁴ Opportunism is a threat *ex ante* to the bargainers' ability (and the ability of other potential contracting parties) to maximize their gains from trade. Opportunism is the enemy of bargains and of efforts to achieve the maximum benefits of bargains.

Alternative goals of contract interpretation that vie with curbing opportunistic behavior include: "uniformly [i.e., predictably] interpreting the contract terms chosen by contracting parties" and "standardization"

21 Schwartz and Scott emphasize the importance of goal achievement, including surplus maximization, in the interpretation process but they emphasize the need to hew strictly to the "parties' solution" in order to implement that goal. Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 *YALE L.J.* 541, 569 (2003).

22 Deadweight loss refers to the aggregate shortfall members would suffer "from a failure to cooperate." ROBERT C. ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* 172 (1991). If parties could control opportunism, they might avoid these losses because they would contract in cases where they would refuse to contract were the opportunism uncontrolled.

23 Robert E. Scott, *The Uniformity Norm in Commercial Law*, in *THE JURISPRUDENTIAL FOUNDATIONS OF CONTRACT AND COMMERCIAL LAW* 152 (Kraus & Walt, eds., 2000).

24 There is always a tradeoff. If courts intervene with terms that save parties drafting costs, the court should be aware that it should not intervene if the cost of enforcement that comes from having to actively interpret a term (or fill a gap) outweighs any savings in drafting costs to the parties. See Posner, *supra* note 3.

of terms.²⁵ To achieve standardization, courts interpret express terms in such a way as to permit deviations and that deviation then becomes a new default rule.²⁶ These new defaults can be invoked by parties in future contracts.

This article posits that the function of the courts in interpreting contracts should include a third goal of discouraging opportunistic behavior as a means of maximizing gains from trade and controlling deadweight losses.

In some ways these different goals of commercial law courts may seem inherently contradictory. How can terms have any predictable meaning if the court “interprets” fixed quantity to mean flexible quantity and thereby creates a new default? However, if courts are sensitive to how the goals can be achieved in each case and when one goal should be trumped by another goal, courts can continue to promote the values that are important to the parties. For example, in some cases discouraging opportunism will require a court to hew carefully to the textual language, simultaneously fostering predictability. In other cases discouraging opportunism, especially in incomplete contracts, will require courts to interpret the contract broadly. Although that approach might arguably impair predictability and autonomy, since the express terms constitute an empty shell and leave certain matters unresolved, the courts cannot simply enforce the express terms as a way of promoting autonomy. Instead, the court has to address whether broad interpretation and law-supplied terms should be embraced as a means of increasing the autonomy by increasing the range of outcomes that the parties can achieve in the face of contracting difficulties. Insistence on adherence to express language should give way to controlling opportunism. Otherwise, textualism would simply be a vehicle for promoting unbargained-for gains for the opportunistic party.

Opportunism arises because parties lack foresight about the future, and because bargaining over possible future contingencies and adding language to contracts is expensive.²⁷ As the context for contractual performance changes, the costs and benefits of the original bargain change and one party or the other may have an incentive to seek to change the nature of the bargain to take advantage of those circumstances by interpreting its obligations in a certain way. Opportunism also arises when one party has the discretion (whether or not made explicit) due to incompleteness that allows that party to make choices in an opportunistic fashion.

²⁵ Scott, *supra* note 23, at 152.

²⁶ *Id.*

²⁷ It is not just the time and expense of bargaining; it is also the wasted time of planning for a contingency that may never occur. These costs of writing contracts may mean that the optimal method of interpretation is a superior approach to literal enforcement since it will relieve the parties of writing terms, though this result may not hold true when “interpretation involves a cost.” Shavell, *supra* note 5, at 301.

The relationship between the court's interpretive function and the role of courts in developing methodologies that reduce opportunism is symbiotic. Opportunism is made possible by the inability of the bargaining parties to specify their obligations in light of future contingencies and behavioral choices, and this in turn drives the need to have an interpretation of the contract in order to determine obligations in a way that curbs opportunism in light of those contingencies and choices.

An opportunistic party may use court interpretation by seeking to have a term interpreted to its advantage and to the disadvantage of both the other party and to the integrity of the original bargain. Sometimes this takes the form of an argument that a term should be interpreted according to its common or plain meaning. At other times it comes in the form of an argument that extrinsic evidence about the meaning of the term should be admitted. That is why the goal of curbing opportunism cannot be taken to call for either one interpretive approach or another. The choice of approach must take into account the opportunism that is presented by different interpretive claims (perhaps by both parties) and that is therefore best placed to restore the parties to the position they would have taken at the time of the original bargain or to curb the problem of opportunism, a goal that both parties would subscribe to *ex ante*.²⁸

The courts demonstrate a willingness to consider (at least implicitly) the opportunism problem in interpretation. They are more willing to call a contract unambiguous and needing no extrinsic evidence when the party attempting to introduce extrinsic evidence appears to be trying to get an unbargained for advantage.²⁹ The converse is also true. Courts are more willing to admit extrinsic evidence when the party insisting on the formal language of the contract is acting opportunistically.³⁰

To provide guidance to courts interpreting contracts, this article will provide a series of heuristics.³¹

²⁸ *Ex post*, of course, a party may prefer to act opportunistically to expropriate a large share of the gains. WILLIAMSON, *supra* note 13, at 63.

²⁹ See *e.g.*, Dixon, Odom & Co. v. Sledge, 296 S.E.2d 512 (N.C. Ct. App. 1982) (court unwilling to admit evidence of meaning of term "former client" when former partner trying to escape contractual obligations to partnership).

³⁰ See *e.g.*, Local Am. Bank of Tulsa v. U.S., 52 Fed. Cl. 184 (2002) (court willing to admit evidence on understanding of how long tax benefit would last when party opposing introduction of evidence trying to opportunistically deny a tax benefit that was critical to the success of the deal).

³¹ Other efforts to provide heuristics to guide courts in the interpretation of contracts include: Katz, *supra* note 9, at 536 (outlining criteria relevant to choosing between formal and contextualized interpretive approaches); BENJAMIN E. HERMALIN ET AL., *The Law and Economics of Contracting* 86 in HANDBOOK OF LAW AND ECONOMICS available at <http://ssrn.com/abstract=907678> (forthcoming 2007) (detailing factors that would make either formal or substantive approach to interpretation economically efficient). The availability of heuristics may help to alleviate some concerns that courts might lack the capability to engage in substantive interpretation because of the greater burdens that such interpretation would place on the

I. THE INTERPRETIVE PROBLEM

When interpreting a contract's express terms, it is tempting to think that the words of the contract are self-defining. If words and terms were so, problems of interpretation would never arise. It is often a mistake to think of words as self-evident, for words are not always an exact expression of the party's intention (perhaps because of inartful drafting)³² and are often susceptible of several meanings, some of which reflect fidelity to the original bargain, and some of which reflect an opportunistic attempt to reformulate the original agreement.³³ In some cases the parties have not formulated an intention so there is no true intention to which the interpretation should remain faithful. When there is no actual intention and the meaning remains uncertain, a party may try to take advantage of the other party by exercising discretion under the terms in a way that does not promote joint gains. In still other cases parties may use "broad" terms that might or might not be intended to apply in different future scenarios.³⁴ Here the parties simply have not formulated an intention *ex ante* on which particular meaning will prevail in what circumstances. For each case in which intention was not formulated, a court must decide what is permitted when the words often provide no solution.

If the parties had been able to anticipate the future and advert to the way contingencies would develop and choices that would have to be made, they could have crafted specific language that took account of the future and opportunistic manipulation would not be possible. Where the agreement does not resolve, address or advert to the manner in which a party might perform his contractual obligations, however, interpretation is required.

The nature of the court's role may be affected by the source of the interpretive problem. If the problem is one of disputed meaning, the court's role might involve a translation role in which the court's job is to

court. See Discussion with Professor Paul G. Mahoney, at the University of Virginia at the American Law & Economics Association Annual Meeting (May 6, 2007).

32 Professors Goetz and Scott refer this as a "definitional process [that] requires parties to employ inherently error-prone signals—the 'formulations' of their agreement." Goetz & Scott, *supra* note 17, at 262. This potential for drafting error "threatens [the] 'reliability'" of the contract. *Id.* at 265. This article broadens the interpretation problem to go beyond mere translation problems created by formulating words to reflect intentions and argues that the fact that the future is unknowable creates another layer of difficulty for parties choosing terms. In some sense, when they choose terms unaware of the future, the terms will be incomplete. Then, when courts "interpret" the terms, there is not only the problem that there may be a divergence between the parties' actual intention and interpretation but a larger problem of interpreting words when there was no actual intention formed to begin with.

33 Goetz & Scott, *supra* note 17, at 266 (discussing errors in interpretation that diverge from the intended meaning as "the risk of unintended effects"). As they point out, these effects are partly the result of giving parties the free choice to pick their own terms. *Id.* at 267.

34 See Shavell, *supra* note 5, at 289 (discussing use of broad terms).

identify the original deal and detect opportunistic attempts to rewrite that deal. The language may clearly cover a contingency and one party may defend arguing that it "never thought the language [it] agreed to would [be such a] disadvantage."³⁵ If the situation is one that is covered by the language and is not a new or unanticipated circumstance in which the language is to operate, courts should and do easily dispose of an argument that the court should not interpret the language as it was intended to operate. In so doing, courts can curb opportunistic attempts to subvert the original understanding.³⁶ When the source of the interpretive problem is the negligent use of words, the law may seek to provide efficient incentives for more careful drafting to ensure that the words accurately express intent, at least if there is a party who clearly could have avoided the ambiguity.³⁷ In these cases the view is that the courts should allocate the loss to the least cost avoider because doing so will maximize the surplus for future parties in similar situations.³⁸ When the parties, however, serendipitously end up having different subjective meanings and neither party is blamable, the law generally takes a hands-off attitude and finds no contract was formed. In such cases there is no basis for supposing that legal intervention in the contract will improve welfare for the parties.³⁹

However, when the source of the interpretive problem is the lack of foresight about the future,⁴⁰ attempts at opportunism and interpretation problems arise that are not likely to be resolved by a careful adherence to

35 This argument may be implicit in a statement that the effect of a particular interpretation is absurd or unreasonable.

36 See *Waina v. Abdallah*, 2006 Ohio App. LEXIS 1941, 2006 WL 1115427 (Ohio Ct. App. Apr. 27, 2006) (where contract awarded payment to broker who assisted in arranging financing but did not actually secure the financing, defendant could not persuade the court to adopt an interpretation that denied broker compensation unless he secured the financing himself since language did not require that).

37 This is the case where courts adopt an objective theory to discourage parties from using language that does not conform to the ordinary objective meaning. The party who most easily could have clarified its intention and failed to do so must suffer the loss.

38 See e.g., JODY S. KRAUS & ROBERT E. SCOTT, *CONTRACT LAW AND THEORY* 883–884 (2002) (discussing least cost avoider).

39 See *Raffles v. Wichelhaus*, 159 Eng. Rep. 375 (L.R. Exch. 1864), for an example in which the court had no basis for supposing that one party or the other was more blameworthy. Consequently, there was no basis for concluding that the court could improve parties' incentives for clarification in comparable future situations by choosing one meaning. *Id.* See also William Young, *Equivocation in the Making of Agreements*, 64 COLUM. L. REV. 619 (1964).

40 As Richard Posner explained in his article on the law and economics of contract interpretation, "[s]o contracts regulate the future, and interpretive problems are bound to arise simply because the future is unpredictable," see Posner, *supra* note 3, at 1582. This lack of foresight may cause parties to "deliberately use vague or 'indeterminate' formulations." Goetz & Scott, *supra* note 17, at 269 (emphasis in original). Interpretation may also arise because parties choose to paper over differences with ambiguous language. See MARVIN A. CHIRELSTEIN, *CONCEPTS AND CASE ANALYSIS OF THE LAW OF CONTRACTS* 94 (2006); Posner, *supra* note 3, at 1582.

the express terms or a hands-off approach. To curb opportunism the court may have to assume a role in intervening through active interpretation. Courts may do this while explicitly adhering to a plain meaning or parol evidence rule.⁴¹

Due to this uncertainty about the future, parties draft economically incomplete contracts.⁴² These contracts are economically incomplete in that they fail to take into account all possible states of the world⁴³ or fail to

Interpretation problems may also arise because the parties attach different meanings to the same words, a problem addressed by the law of misunderstanding in contract law. This is likely to happen when there are terms that have more than one plain meaning. Kraus & Scott, *supra* note 38, at 650. When variable meanings exist and each party attaches a different subjective meaning to a term and neither party is responsible for or aware of the ambiguity prior to contracting with the other party, a court may find no contract exists. “[W]hen neither party is blamable, or both parties are equally blamable, for an incurable uncertainty in their contract, it makes economic sense to allow the contract to be rescinded.” See Posner, *supra* note 3, at 1591. This article will focus on how uncertainty about the future complicates the drafting tasks of parties and the interpretation issues for courts in ways that differ from the case where parties serendipitously happen to contract on a plain meaning unaware that the other party attaches a totally different meaning to the word(s). It will deal with instances when the differing meanings attached by the parties are not so divergent that no contract exists. See Chirelstein, *supra* at 96 (discussing instances where “the element of misunderstanding or ambiguity is simply overwhelming and there is nothing sufficiently common or mutual to make a contract out of”). *Id.* That problem will not be addressed in this article, though a misunderstanding about a certain term forces the court to interpret the meaning using economic principles that trade off the costs and benefits of various judicial approaches to “disambiguating the meaning.” Posner, *supra* note 3, at 1581.

41 For a similar argument that courts emphasize plain meaning while resorting to other implicit considerations, see Eyal Zamir, *The Inverted Hierarchy of Contract Interpretation and Supplementation*, 97 COLUM. L. REV. 1710, 1730 (1997).

42 The recognition that parties will often fail to achieve completely contingent contracts that provide for an optimal outcome in any future state of the world raises the important question of what role courts could or should play in such contracts. This topic of incomplete contracts has been addressed by four law and economic scholars in a recent symposium called *Incomplete Contracts: Judicial Responses, Transactional Planning and Litigation Strategies*. The Symposium appears in 56 CASE W. RES. L. REV. 135–201 (2005). The three articles in the Symposium are by Richard Craswell, Avery Katz, Robert E. Scott and George Triantis with an introduction by Professor Juliet P. Kostritsky. For a pathbreaking treatment of incompleteness see Oliver Hart & John Moore, *Foundations of Incomplete Contracts*, 66 REV. ECON. STUD. 115 (1999).

Scholars working in the law and economics tradition have suggested that courts should use a hypothetical bargain approach to incompleteness, filling in terms that are optimal (efficient) and that the parties themselves would have achieved were it not for the transaction costs. New insights from economics complicate the analysis of incompleteness in contracts. Uncertainty and the cost of and limited access to information are key problems affecting parties both *ex ante* when contracts are being drafted and *ex post* when they are being enforced. This article will explore these effects in the interpretation realm.

43 When the contract fails to take account of potentially different states of the world that may materialize in the future, it is said to be “incomplete because it has a one-state partition in a two-state world . . .” Alan Schwartz, *Relational Contracts in the Courts: An Analysis of*

control future behavior under the contract.⁴⁴ It is often uncertainty about the future that causes a term to be ambiguous even though it appeared to be unambiguous at drafting. A word may have a meaning but it may be unclear whether the parties meant that word to govern no matter what future state of the world materialized and the parties never mentally adverted to the issue *ex ante*.⁴⁵ The terms themselves might call for a certain performance (that seems to raise no interpretive issues) and grant one party discretion on how a party should behave in rendering that performance (or at least there are no express limits on the discretion). Interpretation must resolve whether there are any implicit limits on a party's discretion in how the contract performance is rendered. The job of the court then has to go beyond simply making the original contractual choice transparent or of carefully deciphering the parties' intentions.

If transaction costs were zero and the parties had perfect foresight, as well as perfect ability to craft language that accounted for the future, they might be able (at least theoretically) to craft complete contracts that required no interpretation by courts nor any law-supplied terms.⁴⁶ In a real world of high transaction costs and bounded rationality,⁴⁷ however,

Incomplete Agreements and Judicial Strategies, 21 J. LEGAL STUD. 271, 272 (1992).

Contracts also remain incomplete because problems of uncertainty make it difficult to control for behavioral choices in the future. In such cases "more uncertain environments . . . should leave more discretion to the agent. It is interesting to note that, as uncertainty increases, the optimal contract may become simpler, in the sense of a lower total complexity cost." See Pierpaolo Battigalli & Giovanni Maggi, *Rigidity, Discretion, and the Costs of Writing Contracts*, 92 AMER. ECON. REV. 798, 799 (2002).

44 Of course, deciding if a contract is incomplete and thus requires interpretation or is "complete enough that no reasonable interpretation or implied terms questions arise" is still a concern. George Cohen, *Implied Terms and Interpretation in Contract Law*, in 3 ENCYCLOPEDIA OF LAW AND ECONOMICS 80 (Boudewijn Bouckaert & Gerrit de Geest, eds., 2000).

45 See *infra* notes 136–138 and accompanying text (discussing whether a contract that specified a red part would mean red in all instances even when red part were not available but green (equivalent but for the color) parts were available). The issue is whether the term should have an undifferentiated meaning or whether red might be interpreted to include green if the future materialized in ways that could not be anticipated when the contract was drafted.

46 A complete contract would normally vitiate the need for judicial interpretation. As Professor George Cohen explains: "Economic analyses generally conclude that if a contract is complete, there is no beneficial role for a court other than to enforce the contract according to its terms; that is, incompleteness is a necessary, though not sufficient, condition for an active court role in interpretation . . ." Cohen, *supra* note 44, at 80. See also Luca Anderlini, Leonardo Felli & Andrew Postlewaite, *Modeling Courts in Contract Theory*, Address at Case Western Reserve University (Mar. 28, 2007) (discussing passive role of courts in "frictionless world").

47 For a discussion of bounded rationality as a result of the cognitive limits, see WILLIAMSON, *supra* note 13, at 45. These problems are exacerbated because contracts take place in the unknowable future.

interpretation and gap filling by courts are unavoidable since parties are not willing to incur the infinite costs needed to make a contract complete.⁴⁸

This article concentrates on the interpretation issue. It views it as a subset of the issue of when courts should intervene in private arrangements when contracts are presumed to be incomplete in a number of different ways.⁴⁹ In some ways judicial interpretation—since it starts with express terms—would seem to present fewer instances of direct intervention by courts than is the case when a court supplies missing terms. However, ruling out an active judicial role in interpretation is only possible when courts interpret contracts that use unambiguous language⁵⁰ and are economically complete. Once the possibility of ambiguity due to uncertainty and incompleteness is recognized, this article argues that a broader role for courts in interpreting contracts⁵¹ can be justified on the same grounds that justify the implication of law-supplied terms.⁵² This article rejects the current dichotomous framework, and proposes a framework as well as a list of heuristics useful for deciding when an active approach to interpretation is likely to produce welfare improvement. This framework will use a cost/benefit analysis that takes into account the cost of the behavioral problem of opportunism and the ease or difficulty a court would have in deciding if opportunism has occurred. In addition, the proposed framework and heuristics will take into account (1) whether or not a judicial decision for one party would foster counter-opportunism by the other, (2) the transaction cost of controlling the problem through express contracting, (3) whether any trade practices exist that would provide objective, non-manipulable evidence of a

48 As Judge Posner explains the cost: "perfect foresight is infinitely costly, so that, as the economic literature on contract interpretation emphasizes, the costs of foreseeing and providing for every possible contingency that may affect the costs of performance to either party over the life of the contract are prohibitive." Posner, *supra* note 3, at 1582.

49 The separation of implied terms and interpretive issues is a somewhat artificial distinction since "[i]n some sense, all contract disputes involve questions of interpretation and implied terms." Cohen, *supra* note 44, at 79. Doctrines dealing with implied terms focus on whether a term is being added or a term overridden by a court. Interpretation issues focus on ascertaining meaning in already existing terms. This article will focus on interpretation issues, recognizing that economic analysis might be relevant to both and might provide a common justificative framework for both adding terms and broadly interpreting terms.

50 See *id.* at 81 (arguing that unambiguous "terms represent a confluence of the parties' intentions and the court's ability to interpret those intentions correctly").

51 See Posner, *supra* note 3, at 1587. Judge Posner recognizes that the process of gap filling and of "interpreting" ("disambiguating") contracts present different problems for courts but they are "both, however, interpretive in the sense that they are efforts to determine how the parties would have resolved the issue that ha[d] arisen had they foreseen it when they negotiated their contract." *Id.* at 1586. Interpretation might require a court to decide the meaning of a best efforts clause while a court engaged in gap filling might have to decide whether a best efforts clause should be inserted into a contract. *Id.*

52 The typical justification for a law-supplied term or rule posits that where transaction costs prevent parties from reaching an optimal or first-best outcome, the law should seek to supply a term that the parties would have agreed on absent transaction costs.

practice designed to control opportunism and improve welfare, (4) the informational burden on a court, (5) whether a broad interpretation would control discretion in a contract that would otherwise be uncontrolled under a plain meaning or non-contextualized interpretation, (6) whether literal interpretation would leave one party vulnerable after having invested sunk costs in a way that could be avoided by using trade usage or other evidence to interpret meaning, (7) whether one party would get an unexpected and unbargained-for windfall that could be avoided by a broad interpretation, (8) whether a secret code or idiosyncratic meaning exists that is at odds with plain meaning but that can easily and at low cost be ascertained by using extrinsic evidence to interpret the meaning, (9) whether the admission of the evidence is likely to embroil the court in a difficult to decide issue of whether the evidence shows a practice that is one of grace or of a legal obligation, and 10) the robustness of non-legal reputational sanctions.

II. THE DICHOTOMOUS APPROACH

Scholars have fiercely debated the proper approach for courts to take in interpreting contracts.⁵³ Traditionalists advocate restricting the use of extrinsic evidence, while the contextualists argue for a broad scope for extrinsic evidence in contract interpretation. One particularly controversial matter concerns the degree to which courts should resort to extrinsic evidence such as business customs and norms in interpreting contracts.⁵⁴

The Willistonian classical approach⁵⁵ gave primacy to the written agreement and restricted the evidence that could be used to supplement or interpret the contract.⁵⁶ The court's role was necessarily confined to implementing the parties' intentions as they were reflected in the actual language of the contract. Sometimes this approach is referred to as the four corners approach—a "rule [that] bars the parties to a written contract that

53 For an early trenchant article on the problem of interpretation of contracts, see Goetz & Scott, *supra* note 17 (documenting the negative effect on innovation from a strategy of incorporation). For more recent examples of scholarship addressing the economics of interpretation see Posner, *supra* note 3 and Shavell, *supra* note 5.

54 See *infra* note 55. See also Juliet P. Kostritsky, *Judicial Incorporation of Trade Usages: A Functional Solution to the Opportunism Problem*, 39 CONN. L. REV. 451 (2006); David V. Snyder, *Language and Formalities in Commercial Contracts: A Defense of Custom and Conduct*, 54 SMU L. REV. 617 (2001).

55 "Willistonian formalism rests on two basic claims: (1) that contract terms can be interpreted according to their plain meanings, and (2) that written terms have priority over unwritten expressions of agreement." Schwartz & Scott, *supra* note 21, at 569-570 n. 53. The approach reflected a disinclination of courts to "make a contract for the parties." Goetz & Scott, *supra* note 17, at 273-74.

56 This restricted approach to extrinsic evidence was apparent in the common law doctrine of the parol evidence rule.

is ‘clear on its face’ . . . from presenting evidence bearing on interpretation, which is to say ‘extrinsic’ evidence”⁵⁷

Karl Llewellyn and the legal realists rejected this narrow approach and substituted a more contextualized approach to interpretation in Article 2 of the *Uniform Commercial Code*. Under that approach courts could consider evidence outside the four corners of the contract in order to better ascertain the parties’ true contractual intentions.⁵⁸ The *Uniform Commercial Code* permits the parties to bring in evidence of trade usage, course of dealing and course of performance to interpret and supplement the literal language of the contract.⁵⁹ The *Uniform Commercial Code* also adopted the presumption that trade meaning would prevail unless the parties specifically negated the trade meaning.⁶⁰

The new formalists have attacked this contextualized approach to contract interpretation and suggested a return to greater formalism, embracing plain meaning as the best interpretive approach.⁶¹ They have also argued against admitting extrinsic evidence of trade meaning unless the parties have agreed to have it govern their contract under a linguistic default pegged to ordinary meaning.⁶²

This article argues that the choice of an interpretive approach cannot be made in the abstract without a detailed assessment of which methodology is likely to curb opportunistic behavior and achieve the parties’ goals in a cost-effective way. A suggested framework for contract interpretation

57 Posner, *supra* note 3, at 1596.

58 Llewellyn’s approach to interpretation was reflected in the drafting of Article 2 of the Uniform Commercial Code (U.C.C.). It was founded on the notion that the best way to insure that the laws reflected commercial reality was to admit evidence of merchant practices. This U.C.C. approach admits several categories of context evidence including: course of performance, course of dealing and trade usage. See U.C.C. §§ 1–303, 1–205 (2004).

59 See U.C.C. § 2–202 (1998). The Code provides a hierarchy of preference given to these commercial practices. See U.C.C. § 1–303(e) (2004). Where it is possible to construe the practice and the express language as consistent, it should be done but where it is impossible, the express language prevails. See *id.* Then in descending order, the most particular practice (course of performance in the disputed transaction) prevails over the more general course of dealing in prior transactions and course of dealing prevails over the more general usage of trade. See *id.* For a criticism of this hierarchy, see Zamir, *supra* note 41, at 1714.

60 U.C.C. § 2–202 cmt. 2 (1998).

61 See, e.g., Schwartz & Scott, *supra* note 21. This justification for the narrow interpretive approach is grounded in party preference, since this approach is “what interpretive style . . . typical parties want courts to use” *Id.* at 569. Schwartz and Scott have also rejected a broader role for courts in matters involving state-supplied standardized defaults. *Id.* at 594. They argue that such defaults will be “useless” and “inefficient” and they point to evidence that parties routinely reject such defaults to bolster their conclusion. *Id.* See also David Charny, *The New Formalism in Contract*, 66 U. CHI. L. REV. 842, 842 (1999) (exploring the “phase of ‘anti-antiformalism’ that seeks to discredit and displace Llewellyn’s claim to found commercial law in immanent commercial practice”).

62 Schwartz & Scott, *supra* note 21, at 584–85 (suggesting this default as a way to minimize moral hazard).

follows that is based on understanding the normative justification for intervention in private contracts.

In considering whether extrinsic evidence should be admitted to interpret a contract, a court should carefully consider whether the contract is incomplete and if so, why and how the contract remains incomplete⁶³ and should also consider the type of evidence sought to be admitted and evaluate whether the evidence would promote or hinder opportunistic behavior. The court should inquire into whether there is evidence of a trade practice that is specifically designed to control opportunism.⁶⁴ Different types of extrinsic evidence, including course of dealing, course of performance, and trade usage, should be evaluated to determine what goal the practice or usage was designed to achieve, whether judicial incorporation of the practice would advance that goal, and at what cost.⁶⁵ Courts should also examine the reasons for the omission of the trade practice from the express contract, including barriers that may have prevented the parties' inclusion of a particularized custom or a generalized clause opting into all business customs and practices into their express agreements.

In some cases, the best way to minimize opportunistic behavior by a party when the express contract does not explicitly limit discretion nor expressly incorporate trade usages or practices is to liberally admit contextual evidence of trade usages.⁶⁶ By confining questions of interpretation to those express terms that parties have formed an intention on, and denying context evidence without examining the normative choices involved in admitting or excluding the evidence, the new formalists have avoided inquiry into when courts "are a superior governance mechanism"⁶⁷ when parties have formulated no intention in the contract. This article hopes to illuminate that issue.

63 Schwartz, *supra* note 43, at 272. This article hopes to shed light on some of the reasons that parties' contracts are incomplete and to connect those reasons to an analysis of when legal intervention in the form of broadly interpreting contracts using contextual evidence might produce welfare improvements. See Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 Nw. U. L. REV. 847, 853 (2000) (discussing complication in the court's role in interpreting contracts due to "questions of whether the parties failed to complete the contract deliberately or inadvertently and whether the incompleteness is a product of high transaction costs, asymmetric information, or other endogenous factors"). *Id.* This article suggests that high transaction costs and asymmetric information both contribute to the failure to control opportunistic behavior. Rather than avoiding provision to control opportunism because the parties fear that courts will not be able to judge the matter, as would be the case if the court were judging the state of demand or cost, matters more readily determined by the parties, the parties face insuperable costs in contracting for control of hazard.

64 If the trade practice is of such a type, courts should readily admit the practice as a low-cost means of achieving joint gain by controlling moral hazard.

65 The costs would include evaluating litigation and enforcement costs. See Posner, *supra* note 3, at 1583.

66 See *infra* notes 152, 154 for examples.

67 Cohen, *supra* note 44, at 82.

This article suggests that a model for judicial intervention that can solve interpretive challenges that courts face, while maximizing gains for parties, should strive to minimize the sum of four costs: the costs of contracting, the costs of opportunism including the cost of unremedied opportunism in a literalistic approach, the costs of enforcement and the error costs from intervention (the cost of a court making an erroneous interpretation). The costs of opportunism have been neglected and the error costs have been exaggerated in interpretive questions because error costs have been lumped together in the aggregate to refer to all types of interpretive efforts by courts. If the various types of interpretive efforts by courts can be segregated, and cases where the risk of opportunism are great and burden on the court of identifying opportunism, using the heuristics suggested here or the parties' intentions is low, the risk of error may be low, thereby altering the cost/benefit analyses of active, contextual judicial interpretation.

The costs of contracting include the costs of specification (drafting). The fact that sometimes parties may want to use ordinary meaning and sometimes they may want to use trade meaning may be a subset of specification costs and further complicate them.⁶⁸ Part of the new formalists' aim is to provide parties with incentives to engage in more careful drafting as a way of reducing judicial errors. The view is that if parties devote more resources to drafting, the burden on the court of interpreting the contract is reduced and error costs are minimized. However, this article argues that certain problems may remain resistant to contractualized solutions. In such cases likelihood of the error will be greater with a textualist than a contextualist approach.

The costs of opportunism are several. First, if opportunism goes unremedied, it may deter parties from contracting in the first place or to reduce the incentives to make investments in the contract.⁶⁹ The risk of opportunism may cause parties to undertake expensive precautionary measures such as intensive screening of contracting partners, and extracting bonds or hostages, such as expensive collateral. It may even cause firms to vertically integrate to avoid the opportunistic behavior of a contractual partner.⁷⁰ All of these precautionary measures that reduce the gains from trade constitute a type of transaction cost⁷¹ and so the parties desire to

68 The costs of contracting also include the cost of the parties' needing to know what the law is. There may be value in letting the parties use the language they want in the way they want without having to figure out what the default and opt-out options are.

69 See Katz, *supra* note 9, at 529.

70 See WILLIAMSON, *supra* note 13, at 85-86 (exploring economizing aspects of vertical integration).

71 See JEAN-JACQUES LAFFONT AND DAVID MARTIMORT, *THE THEORY OF INCENTIVES: THE PRINCIPAL-AGENT MODEL 3* (2002) (discussing "additional costs that must be incurred because of the strategic behavior of privately informed economic agents . . . as one category of the transaction cost emphasized by Williamson (1975))."

control this hazard in ways that will minimize the efforts and costs of such control⁷² in order to maximize gains from trade.⁷³

Error costs arise when courts make erroneous interpretations of words having a variable meaning. There are many causes of such errors, including the failure of courts to recognize when parties have trumped implied terms with privately crafted alternatives.⁷⁴ The new formalist view is that error costs inevitably rise with contextualist approaches to interpretation and so should be avoided and only a truncated base of evidence should be admitted. However, once the possibility of incompleteness in contracts is accounted for, then errors of another sort will arise when contracts are interpreted literally, suggesting that at least in some cases, fewer errors will arise with a contextualized approach. If the contract is silent and incomplete in controlling discretion and yet if both parties would want to curb opportunism to maximize gains from trade, then interpreting contracts literally will lead to an error of another sort. It will cause courts to refuse to add any terms controlling discretion, a result that promotes, rather than curbs, opportunism, leading to increases in deadweight losses for the parties.⁷⁵

72 The efforts to control opportunism are subject to a "budget constraint." E-mail from Professor R. J. Coffey, Professor of Law, Case Western Reserve University Law School to Professor Juliet P. Kostritsky, Professor of Law, Case Western Reserve University Law School (July 19, 1996) (on file with author).

It is this anticipation of opportunism that will reduce the amount that the party "would have been willing to pay up front without the prospect of such later cost." E-mail from Professor R. J. Coffey, Professor of Law, Case Western Reserve University Law School to Professor Juliet P. Kostritsky, Professor of Law, Case Western Reserve University Law School (Apr. 28, 2004) (on file with author).

73 See OLIVER E. WILLIAMSON, *MECHANISMS OF GOVERNANCE* 60 (1996).

74 See Goetz & Scott, *supra* note 17, at 263.

75 For a case where a court avoided this trap and interpreted the contract in light of evidence that a narrow interpretation would result in an unbargained-for advantage, see *Local Am. Bank of Tulsa v. United States*, 52 Fed Cl. 184 (2002). In the *Tulsa* case, the court had to interpret a contract to determine what the covenant of good faith required. See *id.* at 189. Although there was a change of circumstance, the withdrawal of the tax benefit that had formed the basis of the deal, since the government had itself lobbied for its withdrawal and at same time secured the bank's consent to a deal on the proffering of such tax benefits, there could be no argument that since the circumstance was a new one that the parties had never contemplated, the contract might have to be interpreted or reinterpreted to take account of the contingency. See *id.* at 191-92. In that case the circumstance, the tax benefits of the deal, formed the very basis of the deal. See *id.* If the bank had learned that the government would work to withdraw the tax benefits that induced the bank to go along with the purchase of some insolvent banks, consent would not have been forthcoming. The court's interpretation precluded opportunistic behavior and thereby helped to facilitate contracting and reduce deadweight losses. See also *Winston v. Mezzanine Invs.*, 648 N.Y.S.2d 493 (Sup. Ct. N.Y. County 1996) (court refused to limit its inquiry to contract document in its interpretation of "priority return" and effect was to curb the discretion of the general partners whose own preferred interpretation would have "undercut" the purpose of tailoring the payment to the manager's performance). *Id.* at 503.

III. THE CASE FOR LITERAL INTERPRETATION AND A “MINIMUM EVIDENTIARY BASE”⁷⁶

Before examining how a flexible interpretive methodology geared toward preventing opportunism in incomplete contracts⁷⁷ would operate and might lead to welfare improvement, the new formalists’ arguments in favor of literal interpretation and a truncated base of extrinsic evidence should be addressed. The article will highlight the assumptions and the limitations of the approach, especially when applied to incomplete contracts. It concludes that the arguments for a unified approach of literalism fall short because they ignore the need for courts to make normative choices in interpreting contracts that are incomplete.

The case for a literal interpretation—made by the new formalists—built on a narrow base of extrinsic evidence posits an unrealistic model that assumes complete contracting.⁷⁸ In an important recent article, Professors Schwartz and Scott, two exemplars of the new formalism, have embraced plain meaning and argued that the default rule for contract interpretation should be a narrow Willistonian one that admits only a “minimum evidentiary base,”⁷⁹ unless parties specifically opt for a broader approach to interpretation.⁸⁰

Schwartz and Scott argue that a Willistonian exclusion of extrinsic evidence would reduce contracting costs, minimize moral hazard problems, reduce interpretive errors by courts and facilitate more efficient, complex contracts.⁸¹ The pair assert that parties should be able to choose which

76 See Schwartz & Scott, *supra* note 21, at 573. This restricted base is known as B_{min}. See *id.* (“[T]he mitigation of hazards can be the source of mutual gain”). WILLIAMSON, *supra* note 73, at 60.

77 Incompleteness might take the form of failing to address specifically what the implied covenant of good faith is. See *Local Am. Bank of Tulsa*, 52 Fed. Cl. at 189–90. (interpreting content of good faith covenant to preclude withdrawal of tax benefit that formed basis of the deal).

78 Both models of judicial interpretation, as discussed by Schwartz and Scott, “suppose that the contract is complete in the sense that the writing expresses the parties’ solution to the contracting problem at issue.” Schwartz & Scott, *supra* note 21, at 573.

79 See *id.* (suggesting a textualist approach to contract interpretation built on a minimum evidentiary base is the approach that parties would prefer).

80 There are certain exceptions including cases in which the fact of bias-free judicial decisionmaking is not satisfactory. In certain contexts, parties are favored or disfavored by a court’s interpretation and may gain or lose by a court’s error. In other contexts, such as the perfect tender rule, “the seller wants the court to find the correct answer with certainty” because it will gain no extra advantage when its quality passes muster and will lose everything if its quality is below the standard no matter the amount of deviance. *Id.* at 578. This means that “when a court is only right on average, the seller’s expected payoff under the contract is less than its expectation interest.” *Id.*

81 See *id.* at 584–88. Scott and Schwartz argue that this inefficiency (of using simpler contracts that are inefficient) in contracting will be caused by a contextualized approach to

interpretive default will govern their contract.⁸² Because parties, on average, prefer a restricted evidentiary base, courts should apply this preference as the default rule in contract interpretation.⁸³

Because the Scott/Schwartz model, as do many textualist models, assumes that judicial interpretation should be confined to cases where parties have formed a complete contract⁸⁴ the court's interpretive role is limited to ascertaining what the parties intended by their contractual language—the "correct answer".⁸⁵ The model thus adopts a factual or "semantic" approach to the problem of contract interpretation.⁸⁶ The very fact that the new textualists seek an interpretive style that the "parties [would] want courts to use when attempting to find the correct answer"⁸⁷ demonstrates the limits of the formalistic search for the preferred interpretive style. When contracts are incomplete, there is often no such thing as a "correct answer" since the parties never formed an intention that courts could later identify as the "correct answer." Thus, the search for an interpretive style that courts should use and that parties would prefer courts use to identify the correct answer will not identify what interpretive style parties would prefer courts to use when the contract is incomplete and there is no correct answer.⁸⁸ Artificial limits on the court's interpretive role—limited to finding

interpretation. *See id.* at 587–88. Under a contextualized approach the error rate is likely to be greater than it would be under a plain meaning regime. This error risk will cause parties to "use simpler, but possibly less efficient, contracts." *Id.* at 587–88. This article suggests that in some cases a simpler contract will be more efficient and the risk of error under a contextualized approach to interpretation will vary depending on the type of contextual evidence at issue. Thus, the article would disagree with the Schwartz and Scott unified and reflexive conclusion that "contextualist regimes increase the likelihood and cost of disputes . . ." *Id.*

82 *See id.* at 569 (discussing party sovereignty).

83 *See id.*

84 *See id.* at 573. Both models of judicial interpretation that Schwartz and Scott discuss "suppose that the contract is complete in the sense that the writing expresses the parties' solution to the contracting problem at issue." *Id.* They make this assumption since "[c]ourts can only interpret what is said, so our analysis assumed that the parties' writing was complete for the subjects at issue." *Id.* at 594. But deciding what the writing said and whether it was complete or not cannot be resolved without a normative theory of interpretation. The real issue is when state intervention in economically incomplete contracts is likely to be welfare maximizing or not given the costs and benefits of the particular intervention.

85 *Id.* at 568–69.

86 Such contracts may be economically incomplete because they address an issue directly, but fail to provide terms that control the exercise of discretion arising in connection with that term.

87 Schwartz & Scott, *supra* note 21, at 569.

88 The failure of the text to contain a correct answer can also occur when the parties implicitly assumed that the contract language would operate in one context and a different context materializes. Professor Bowers explains: "[i]f the context that actually occurred differed substantially from that implicit in the formulation of the contract clause, it may be that the parties never had any agreement in the first place. If the context is really unprovided-for, the contract is truly incomplete. There is no 'correct answer' . . ." James W. Bowers, *Murphy's*

the correct answer—only make sense if one accepts without reservation the notion that the contract at issue is complete and that parties actually form an intention on all matters that are covered by the express language or that might come up.

Another key assumption by Schwartz and Scott, connected to the assumption of a complete contract, is that a court's role should be limited to "find[ing] the correct answer . . . to a contracting problem that the parties *intended* to enact."⁸⁹ Their view is that both party autonomy and efficiency require the adoption of this approach to contract interpretation.⁹⁰ If the court is not restricted to determining "just what the person had agreed to do,"⁹¹ then the court would not be facilitating autonomy or maximizing the surplus for the parties. Only when courts implement the parties' actual solution is there evidence that the deal is value maximizing.⁹²

Schwartz and Scott advocate for party autonomy by restricting the court's interpretive role to implementing the parties' actual solutions.⁹³ They suggest that a "sufficient" justification for court intervention in contract disputes lies in the "court . . . making the person do what he agreed to do."⁹⁴ Schwartz and Scott assume that the language enacted will allow the court to discover an actual intention of the parties that should be given effect.

However, the issue for modern contract theorists and legal decision makers is whether and when legal interpretation can be justified when the parties' agreement is silent or unclear, raising the question of whether there are other bases that would provide an alternative "sufficient" justification for judicial resolution of a contract dispute. In fact, as Steven Shavell recognizes, even if (as is often the case) the parties adopt a broadly inclusive express term, it is not clear that they would really want such a term "enforced as written in the particular contingency that occurred."⁹⁵

Law and the Elementary Theory of Contract Interpretation: A Response to Schwartz and Scott, 57 RUTGERS L. REV. 587, 603 (2005).

89 Schwartz & Scott, *supra* note 21, at 568–69 (emphasis added). "This goal [of efficiency] is unattainable if courts fail to enforce the parties' solution but impose some other solution. Thus, the court must ascertain the solution that the parties actually adopted." *Id.* at 569.

90 *Id.* at 569.

91 *Id.* Their hypothesis seems to be that parties will contract to maximize the surplus that a deal creates—this is evidenced by the fact that they made the deal, period. This hypothesis is only acceptable if there are no informational asymmetries, or systemic defects in parties' ability to gauge risks or to perceive the future. When there are such shortcomings, it may no longer be clear that the literal contract interpretation maximizes surplus.

92 *Id.*

93 *See id.*

94 *Id.*

95 Shavell, *supra* note 5, at 292. An example that Shavell uses is one in which a "general term is interpreted as written but does not always result in the ideal act for the parties: This occurs when a general term (E_j, a_j) is interpreted as written, the parties do not want a_j to be performed in a least some contingency θ_i in E_j , but the expected gain from an alternative contract (writing an explicit term for θ_i , including θ_i in another general term, leaving a gap) is

When parties have formed no particular intention on whether and how far to enforce a performance obligation, searching for an actual intention will be unavailing.

A formalist theory of interpretation by its own design simply does not have anything useful to say when contracts are incomplete. Because Schwartz and Scott assume the parties have reached a complete contract and because "[e]conomic analyses generally conclude that if a contract is complete, there is no beneficial role for a court other than to enforce the contract according to its terms....," it is not clear why there are any complicated interpretive questions that would arise that would require judicial resolution.⁹⁶

Because parties often fail to formulate a particular intention as to whether a written term should apply in a particular instance or whether the performance obligation stipulated in the express terms should be interpreted to contain implicit limits on how the performance obligation is rendered, it is impossible to separate questions of contract interpretation from normative theories that allow a court to intervene in incomplete contracts or to fill gaps. Because contracts remain incomplete, a theory of interpretation that insists on confining the judicial role to the express terms and an actual party's intentions, the theory can have nothing to say on how incomplete contracts should be resolved. Schwartz and Scott have determined that they would bifurcate interpretation questions (semantic) from "determining the legal significance that should attach to the semantic content."⁹⁷ Once one admits that intentions may be unclear on the scope of the clause or that no specific intention may have existed, then it becomes incumbent on courts to justify their interpretation by resorting to some model of what the parties would consider an ideal (optimal) interpretive solution, making bifurcation of interpretation and normative theories of gap filling unrealistic.

Often contracting problems are not susceptible to a contractual solution and an agreement may be reached by the parties without solving all of the parties' problems. One problem that is particularly difficult for the parties to control by express language is the problem of party behavior. Since it is "costly to describe . . . the parties' behavior,"⁹⁸ in many contracts, parties will not be able to anticipate all of the various ways that each can take advantage of the other.⁹⁹ Contracts allow for discretion when it is

lower." *Id.* at 299. Thus, in some cases it would be optimal for the court to not interpret the contract as it is written.

⁹⁶ Cohen, *supra* note 44, at 80. If all contracts are complete and assumed to be written in ordinary language, then the court's job would seem to be one of enforcement.

⁹⁷ Schwartz & Scott, *supra* note 21, at 568 n.50.

⁹⁸ Battigalli & Maggi, *supra* note 43, at 799 (emphasis removed).

⁹⁹ *Id.* at 811.

impossible to carefully control all aspects of an agent's behavior.¹⁰⁰ Because of uncertainty, it is prohibitively expensive to draft a complete contract that accounts for all the ways an agent can act opportunistically.

Confining the interpretation problem to simply finding out the parties' intentions based on the express language of the contract, as textualists would do, neglects the fact that contract interpretation should involve more because parties actually enact the problem of incompleteness in their contracts. Many of the parties' potential problems are not addressed in the contract because of various barriers to inclusion.¹⁰¹ In addition to drafting costs, which hinder detailed contracting to control behavior of an agent and opportunism, the parties may neglect to include a general clause term controlling opportunism because the generalized commitment not to act opportunistically applies to so many contexts that parties may assume that they are implied terms.¹⁰² They may also be so vague as to be unenforceable¹⁰³ and may not be believed.

For the above reasons it is incorrect to assess a theory of interpretation along the two dimensions that Scott and Schwartz suggest: "(1) the likelihood that the style of contracting will generate the correct answer . . . and (2) the costs that the style imposes on courts and parties."¹⁰⁴ Assessing a theory of interpretation according to its ability to reach the correct result is defined in terms of ascertaining what the language adopted by the parties was intended to mean is not a broad enough basis upon which to assess the success of an interpretive theory.

Instead, to be successful, a theory should be able to guide the courts when the language adopted is ambiguous, when the parties have not formed any clear intention on the meaning or scope of the words used and when there are actual gaps or when the contract is obligatorily complete but economically incomplete.¹⁰⁵ The contracts are inefficient because they fail to provide for outcomes that are tailored to specific contingencies that develop. In an ideal costless world, the contract would permit a seller an excuse if the seller's costs exceeded the value that the buyer placed on the good.¹⁰⁶ Moreover, because it will often be impossible to identify the

100 Cohen, *supra* note 44, at 89 (discussing the principal-agent contracts as "[c]lassic examples of high-transaction costs contracts"). This is in large part because of the uncertainty as to future choices that the agent might have to make on behalf of the principal.

101 The barriers to inclusion are: the complexity of the environment, uncertainty about future events and uncertainty about future behavior of the parties.

102 Juliet P. Kostritsky, *Bargaining With Uncertainty, Moral Hazard and Sunk Costs, A Default Rule for Precontractual Negotiations*, 44 HASTINGS L. J. 621, 673 (1993).

103 WILLIAMSON, *supra* note 13, at 63.

104 Schwartz & Scott, *supra* note 21, at 573.

105 See Robert E. Scott & George G. Triantis, *Incomplete Contracts and the Theory of Contract Design*, 56 CASE W. RES. L. REV. 187, 190–191 (2005) (explaining how a contract can be obligatorily complete but "incomplete in the economic sense").

106 *Id.*

parties' intentions, intention cannot form a linchpin of a broad interpretive theory. Schwartz and Scott's narrow assumptions limit their ability to create a broader theory that would apply to cases involving incomplete contracts. In such contexts one cannot isolate the interpretation or language question from the context of the problem that contractual language is crafted to solve as well as the transaction costs associated with crafting solutions. The formalists' attempt to isolate the interpretation issue from the factual context under which contracts are made, including the barriers that preclude complete contracts, distorts the cost/benefit analysis of literalism and contextual interpretation.

The exclusion from consideration of incomplete or ambiguous contracts from their theory of interpretation allows Schwartz and Scott to build their argument for a party preference for a literalistic contractual default. This article will examine their technical arguments for a minimum evidentiary base as the preferred interpretive default against the background of incomplete contracting.

They posit that if one restricts the evidentiary base to the minimum one, the courts will be able to find the "correct answer"¹⁰⁷ with "positive probability."¹⁰⁸ They concede that if a court considers and admits extrinsic evidence beyond the minimum evidentiary base, it is more likely to reach the correct answer in a particular case.¹⁰⁹ Thus, more contextual evidence can reduce the variance defined as the court's "deviat[ion] from the correct answer."¹¹⁰ However, since parties are on average risk neutral, and "[a] risk-neutral party cares about the mean of the interpretation distribution but not the variance,"¹¹¹ they are only concerned with whether on average courts will find the correct interpretation and not with variance.¹¹² Sometimes courts will make errors, but if "[j]udicial errors . . . cancel in expectation,"¹¹³

107 Schwartz & Scott, *supra* note 212, at 575.

108 *Id.*

109 *Id.*

110 *Id.*

111 *Id.* at 576.

112 Professor Bowers makes a different but powerful argument against the notion that parties do not care about variance but only about whether on average courts get the correct result. Thus, courts could reach extreme results that varied from the correct interpretation, but as long as they reached extreme results in the opposite direction, then parties would be indifferent to these wide variations. However, Professor Bowers points out that the greater variance from the correct interpretation may actually "create greater moral hazard than narrower, more limited variances do." Bowers, *supra* note 88, at 601. The important point to note about this argument is that parties would like to reduce the degree of variance in order to discourage opportunism and "[i]f, therefore, considering contextual evidence in any contract dispute tends to narrow the variances of the error, firms might in fact prefer Corbin style contextualist contract interpretation rules . . ." *Id.*

113 Schwartz and Scott, *supra* note 21, at 575. This is because "the court is unbiased . . . [and] is as likely to make an interpretation that is more favorable to the buyer (less favorable to the seller) than the correct answer as the court is likely to make a less favorable interpreta-

then on average courts will get the correct interpretation and that is all that risk neutral parties care about.¹¹⁴ Moreover, because admitting more evidence and increasing the evidentiary base will be costly, and will not ensure an error-free result, the increased accuracy will not be worthwhile to the risk neutral party who cares not about accuracy in a particular case but about average accuracy across a broad range of cases.¹¹⁵

This article argues that before accepting the implications that risk neutrality has for the preferred interpretive approach, the differing meanings of risk neutrality should be explored.¹¹⁶

In one of its two distinct meanings, risk neutral parties comprise those who “in arriving at the *present* value of a future stream of possible values, do not discount the *ex ante* expected value (that is, the weighted arithmetic mean of future values) in light of their uncertainty, (risk)”¹¹⁷ The assumption is that most actors, including firms and residual claimants, are not risk neutral in this sense of evaluating the value of projects that they might invest in or reach a contract on. Even if they have insurance to cover the risks associated with more uncertain streams of future income, that insurance is costly¹¹⁸ and firms are not indifferent to the risks.

There is a second sense in which firms are thought to be risk neutral and that is “with reference to *selecting from among* risky projects after valuation of a future income stream of risky values has been correctly established in light of risk.”¹¹⁹ At this second stage, if managers can costlessly shift from one risky project to another, then as amongst those differing and risky projects, firms are risk neutral. This is the sense in which economists mean to refer to firms being risk neutral. After having done the initial valuation that includes risk as a component, firms might then decide to invest all of their assets in risky ventures.

Ex ante in evaluating future projects, however, firms do pay attention to the risk associated with the future income stream. For that reason, we can assume that risk does play a role in terms of what projects and what

tion.”

114 Schwartz and Scott assume that firms are risk neutral. *Id.* at 576.

115 *Id.* “This is because the variance term measures risk while risk-neutral parties are indifferent to risk.” *Id.*

116 I am indebted to Professor Ronald J. Coffey for pointing out this distinction.

117 E-mail from Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School of Law (Dec. 15, 2006, 11:42 EST) (on file with author) (emphasis in original); see also Katz, *supra* note 9, at 526 (discussing risk of varying “information sets”). PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION AND MANAGEMENT* 465 (1992) (discussing relationship between risk and “computing present values”).

118 Professor Coffey points out that: “There is a cost to insurance, however, which reduces present value the same as a discount rate would without insurance.” Coffey, *supra* note 117.

119 *Id.*

contractual transactions firms will invest in. Once that point is recognized, then in choosing the correct interpretive approach, courts should adopt an approach that will reduce overall risk for parties, since firms are not indifferent to risk in the initial evaluation of whether to invest or contract when there is risk associated with it.

So if firms are not indifferent to risk at the time they are making the initial evaluation of future income streams, risk and the need for insurance to guard against risk, as opposed to the second level determination of substituting one risky project for another, then firms would value various strategies, including contractual interpretation, that reduced risk, including the risk of opportunism. Courts should only be free to ignore risk when parties themselves would be indifferent to risk, as they would be in choosing amongst risky projects.

The notion that parties may be affected by whether courts adopt optimal interpretations—a rejection of the Scott/Schwartz view that parties care only about getting a correct answer on average—is reflected in Professor James Bower's argument that deviation by courts from an optimal interpretation may significantly impact parties' decisions to contract with other parties. As Bowers explains, if a correct interpretation will maximize joint gains for parties, an erroneous interpretation by courts could result in a low enough gain that parties would simply forego contracting altogether and proceed separately.¹²⁰ It is in this sense that firms may not be indifferent to erroneous interpretations.

The deviation from a correct interpretation, to the extent that it increases the risk of opportunism and shields one party from the adverse consequences of its opportunism, has a parallel in financial economics. In that context, "the agent's 'propensity to diverge' [is viewed] as creating the prospect of a negative future return stream to the firm."¹²¹ For that reason firms strive to control that "propensity to diverge" [© R.J. Coffey] and search for cost-effective methods of controlling that risk.¹²²

This article argues, therefore, that contracting parties share a similar preference for controlling the risk of opportunism as a means of increasing joint gain.¹²³ The dichotomous approach of the new textualists to interpretation that gives total preference to the words and rejects a broad extrinsic base and trade meaning, unless specifically opted into, may not achieve parties' functional goal of reducing the risk of behavioral opportunism and so should not be preferred.

Part of the textualists' embrace of plain meaning can be explained by their isolation of the interpretation issue from the bargaining context under

¹²⁰ Bowers, *supra* note 88, at 607.

¹²¹ E-mail from Professor Ronald J. Coffey, Professor of Law, Case School of Law to Juliet Kostritsky, Professor of Law, Case School of Law (Dec. 19, 2006) (on file with author).

¹²² Doing so will act as a source of gain for the firm.

¹²³ WILLIAMSON, *supra* note 73, at 60.

which a contract is made, including the limitations on the parties' ability to achieve their functional goal of maximizing gains from trade through the reduction of the risk of opportunism. That isolation distorts the comparative cost/benefit analysis of literalism and contextual interpretation. Yet one cannot isolate the interpretation or language question from the context of the problem that contractual language is crafted to solve as well as the transaction costs associated with both courts and parties crafting solutions to those problems.

In deciding which approach to admissibility of extrinsic evidence on interpretation questions is preferable, account should be taken of one the major problems contracting parties' face—uncertainty about the future and especially about the potential choices that a party will have to make in carrying out its performance obligations under the contract. Ideally, the court's interpretation should control party discretion to deter opportunism,¹²⁴ at least if such "interpretation" does not create other greater risks of court error or facilitate counter-opportunism by the other party. Discretion is most likely to occur when it is costly to describe all of the varieties of opportunism and behavior that are likely to occur in a contract.¹²⁵

The problem of discretion and opportunism would often remain unaddressed were contracts literally interpreted; literalism would fail to control the forms of opportunistic behavior parties may engage in when carrying out their express performance obligations.¹²⁶ When the

124 This discretion may arise when one party is expressly given the power to make choices in a contract (as in a requirements contract where the buyer may elect to tell the seller what its requirements are) or it may arise because the contract is incomplete due to uncertainty. If there is uncertainty, one party may be hired and the contract may remain simple and obligatorily incomplete, forcing the party hired to make choices in a variety of cases. A babysitter must decide when to take the baby outside, etc. See Battigalli & Maggi, *supra* note 43, at 801 n.5. A contract may also be obligatorily complete in general terms (a red widget in all cases; see *infra* note 136) but economically incomplete. It does not take account of some future contingency that might affect whether the specified choice is appropriate in all contingencies. In those cases, there is arguably an element of discretion that requires judicial interpretation. If the contract is obligatorily complete in general terms but it does not address what would happen in a contingency, the question is whether the court should deviate from the literal meaning.

In other cases the contract may not be obligatorily complete. There may be no controlling term at all telling a babysitter what to do in various situations. See Battigalli & Maggi, *supra* note 43, at 801 n.5. Or, there may be no controlling authority on how to handle one's discretion in doing a job as a headhunter collecting resumes. See *infra* notes 149–50 and accompanying text. In these cases as well, judicial interpretation may be required in order to maximize value.

125 See Battigalli & Maggi, *supra* note 43, at 801.

126 Of course the opportunism may be controlled by extra contractual devices such as reputational sanctions, but in some cases the gains of opportunistic behavior might outweigh the cost from the reputational sanction, making a judicial sanction necessary. Karen Eggleston, Eric A. Posner & Richard Zeckhauser, *The Design and Interpretation of Contracts: Why Complexity Matters*, 95 Nw. U. L. Rev. 91, 116 (2000).

inevitable uncertainty of parties' behavioral choices and the need to control opportunistic behavior are accounted for, the insistence on literal interpretation of contracts and a restriction to the "minimum evidentiary base" are likely to be counterproductive. The contractual language may be precise yet fail to address or control for behavior that might arise in connection with how a party carries out its duties under the words, leaving an element of discretion in the contract. If the interpreter considers the possible range of choices in behavior that one party might make while complying with the language, then a literal, narrow semantic interpretation will not be value-maximizing because it will fail to control opportunistic behavior. When gaps exist or the words encompassing behavioral choices themselves require "legal" interpretation, courts may need to resort to an interpretive approach that makes normative choices.¹²⁷

If the parties' intentions are unclear on the scope of the clause or no specific intention may have existed or discretion exists, then it becomes incumbent on courts to justify their interpretation by resorting to some model of what the parties would consider an ideal (optimal) interpretive solution, making bifurcation of interpretation and gap filling models unrealistic.

When contracts are incomplete (as they inevitably are), the refusal to admit extrinsic evidence leads not only to occasional errors with a correct result on average (the result predicted by Schwartz and Scott), but also to judicial decisions that do not maximize surplus.¹²⁸ When the contract is silent, or when it affords broad discretion to a party—a large subset of contracts cases—an interpretive default rule that relies on the express language of the contract simply will not achieve the parties' goals.¹²⁹ In such cases the court will be unable to ascertain the parties' intentions from the express language, yet the contract will still require interpretation. Maximization of joint value for the parties is the principle that should guide this interpretive process.

The court's interpretive methodology, including how much extrinsic evidence is admitted, should depend on which methodology will curb opportunism in a cost-effective manner. Textualism may provide a solution if the terms that parties agreed to completely address a problem. In such cases if the court takes a term and broadly interprets it beyond

127 If you admit ambiguities in either plain meaning or the relevant norm, then "even the proper application of either strategy will serve at best to limit the range of interpretive disagreement." KRAUS & WALT, *supra* note 25, at 194-95.

128 This point is consistent with Professor Bower's insight that interpretive errors may result in the loss of a surplus as parties decide to forego contracting because acting alone they may achieve gains that exceed those from an improperly interpreted contract. Bowers, *supra* note 88, at 607.

129 This search for a fictional intent that may not exist versus formulating an approach that will be responsive to parties' needs and goals has a parallel in the debate between the originalists and the consequentialists in constitutional interpretation.

the scope intended by the parties, then there will be negative economic consequences. “For example, if a court imposes a stronger performance obligation on an obligor than the parties intended, then future obligors will extract a higher price....”¹³⁰ In these cases courts are reallocating the original obligations, a result that will not maximize value since the contract was priced on the original obligations, not expanded ones.

However, textualism may engender negative consequences, at least if the contract being “interpreted” is incomplete in the sense of not controlling behavior. An example,¹³¹ to be developed later, is as follows: A headhunter is hired for a fee. The company agrees to pay for any of the headhunter’s referrals that the company actually hires. A literal interpretation might suggest that the company would have to pay if it hired one of the referrals even if the headhunter did nothing but amass the resumes of all U.S. citizens. Such an interpretation, while literally compliant, would neglect the fact that there is a hidden element of discretion (not spelled out) in what the headhunter must do to earn its fee.

The problem with an entirely textual approach to contract interpretation is that in many cases there is express language but the parties have formulated no intention on the meaning or none that can be discerned from the text itself. In addition, what seems like an express term (the payment of a fee to a headhunter for resumes presented) may actually shield the fact that one party (the headhunter) is going to exercise discretion under the contract that needs to be controlled; a semantic interpretation would simply accept the literal term.

If one applies a textualist approach that does not allow for implied terms or a broad approach to judicial interpretation, then courts will be unable to solve some critical problems for the parties, which failure will engender

¹³⁰ Cohen, *supra* note 44, at 84.

¹³¹ This example is from Professor Aaron Edlin. *See infra* note 149.

deadweight losses.¹³² This deadweight loss is something that the parties would want to avoid *ex ante*.¹³³

Thus, in such cases, where the court narrowly confines itself to the minimum evidentiary base but the contract is silent on a problem to be solved, the expected judicial interpretation would involve a 100% error rate. Even parties who were risk neutral in the sense posited by Schwartz and Scott would want the court to admit the extrinsic evidence to avoid such a large error rate. Not adding it would mean that the court has absolutely no chance of solving the parties' problems and in such cases literalism will not be a preferred or value maximizing strategy.¹³⁴ If one accepts that firms are not indifferent to risk, at least in evaluating projects initially and deciding which contracts to put resources into as distinct from the decision to substitute one risky project for another when selecting among risky projects,¹³⁵ then the 100% error rate or risk would not be value maximizing for the parties.

Schwartz and Scott make other (instrumental) arguments in favor of literalism. They posit that a literalistic regime will reduce error and contracting costs and minimize the opportunity for moral hazard. This article concludes that a literalistic interpretive default's assumed advantages become less compelling when one distinguishes between different types of contextual evidence that may be admitted and develops heuristics to guide a court. A blanket prohibition on contextualist evidence should not govern. Textualist defaults also lose much of their appeal when decision makers pay adequate attention to the fact that contracts will often incompletely

132 Schwartz and Scott would argue that implying terms in the form of default rules can be counterproductive by increasing moral hazard. Thus, if one were to create a state default rule that is conditioned on asymmetric information, then the parties will often be "exploited for private ends." Schwartz & Scott, *supra* note 21, at 608. If a state seeks to complete a contract that is economically incomplete because it does not condition on different states of the world by for example making the price depend on the state of the demand, a state supplied rule premised on such unverifiable factors as the state of demand is likely to be inefficient. Courts will not be able to determine what the state of demand is and so parties, knowing that, would have avoided drafting a contract conditioned on that variable. A court's supply of this term would therefore be inefficient. *See* Schwartz, *supra* note 43, at 272.

This article suggests that while certain state supplied default rules may be inefficient for the reason that parties themselves would have avoided conditioning on certain variables, the state can play a productive and efficient role in the interpretation of contracts even when it goes beyond the evidentiary base and judicially interprets incomplete contracts. The conditions for efficient interpretation are explored *infra* in the Methodology section of the Article.

133 *See supra* note 22.

134 This article assumes that the other private devices for controlling opportunism and discretion such as reputational controls, tit for tat strategies, contractual devices, bonding, monitoring and screening are costly and might outweigh judicial intervention costs to police opportunism.

135 *See supra* note 118.

control a party's behavior if one adheres to a literalistic interpretation of the language.

IV. EXAMPLES: BOTH REAL AND IMAGINED

In the following hypotheticals and examples, the parties have neglected to provide for a future contingency, such as an unanticipated shortage, or have neglected to control discretion under a contract. In each case the court must confront whether it should intervene by incorporation of a trade usage or some other extrinsic evidence for interpretation purposes. In these cases contextualism would produce joint welfare gains, assuming that court intervention is cheaper than self-enforcement and that conditions of uncertainty, bounded rationality, and sunk costs exist.

If a contract, for example, specifies red, "red" may not mean "red" at all.¹³⁶ It is possible to envision a trade usage where a party agrees to purchase red component parts, but routinely accepts green parts if, for some reason, red parts are unavailable. In this situation, "red" may mean "red unless there is a shortage of this part, in which case it means green."¹³⁷ "Red" is just a crude tool that the parties use as an efficient placeholder when it is costly to express a complex idea. Parties are forced to resort to simple language like this because they face limitless specification costs to draft a fully contingent contract that accounts for every possible future state of the world, including whether a party would ever be able to satisfy its obligations with a non-red widget. The contract is therefore incomplete in failing to condition performance on a particular future contingency.

A manufacturer of television sets could encounter such an ambiguity when it contracts for the purchase of red plastic widgets that hold circuit boards in place. The price of plastic dye could go up considerably, making un-dyed green plastic widgets cheaper. The part is an internal component that the consumer never sees, and it does not affect the functionality of the product. Producers of televisions prefer to use red widgets for consistency's sake (it may be an industry standard to which all producers adhere). However, there may be a custom that green widgets are acceptable when the production of red widgets is interrupted by market forces (perhaps there is a competing industry that is cyclical and has a large demand for red widgets, perhaps the dyes are difficult to procure, or come from a

¹³⁶ I am grateful to Michael Doty for this example. If one contracts with the Target corporation "red" likely means a particular shade of red that is much more specific than the general term "red."

¹³⁷ This case might provide an example of a case in which the contract is obligatorily complete but not fully detailed because a contract that says to use red "no matter what is not fully detailed but is obligatorily complete." See Shavell, *supra* note 5. In cases such as these, Professor Shavell suggests that there may be a reason to offer an interpretation that differs from the literal interpretation. *Id.* at 299 (suggesting cases where interpreting the terms as written "does not always result in the ideal act for the parties . . .").

region suffering perennial geopolitical instability, etc.). If every television manufacturer accepts green widgets when red ones are unavailable, or are too expensive, then “red” in a contract for “red widgets” would have an inherently uncertain meaning. Under these cases, it might make sense to admit the trade usage.¹³⁸

In this example, the producer of the red plastic widgets would have a performance obligation to supply red plastic widgets. Yet, the contract is incomplete: it fails to specify what to do when the red plastic widgets become unavailable. It therefore raises the question of whether the producer has the discretion to manufacture green plastic widgets and whether doing so would satisfy its performance obligation to the manufacturer of television sets to supply red widgets. These are questions of interpretation that cannot be resolved under a literal interpretation or an approach that searches for the correct solution that the parties have formulated their intentions on.

To decide whether extrinsic evidence of a trade practice should be admitted as part of a broad approach to interpretation, a court should consider why the parties omitted the practice, whether interpretation would help to control or worsen opportunism, whether the practice was specifically designed to curb opportunistic behavior and whether a court is able to judge whether opportunism has occurred *ex post*. One mechanism that the parties develop as a means of controlling such opportunism and where the contract remains silent or incomplete is the trade usage. The heuristic from this case is that courts can and will apply a trade usage to interpret a contract when the court does not need to engage in complex determinations about whether the usage applies in all cases or only in a narrower group of cases such as when the other party is not itself acting opportunistically. When a party insists on plain meaning to displace a universal usage, it is likely to be an opportunistic action that the court should not promote. Because the usage is designed to control opportunism, a deviation itself constitutes good evidence of party opportunism. Courts readily enforce such trade usages when they can easily ascertain whether one party has acted opportunistically in violating the trade usage.¹³⁹ Restricting the evidence to the “minimum evidentiary base”—the express terms—would hamper the control of opportunism and increase moral hazard.

138 The case might be a more difficult one for a court to decide if there were no trade usage and the court had to determine whether the change in circumstances would call for a different interpretation and a variation from a red widget. The risk of error might be greater than if a court could rely on a trade usage.

139 When the trade usage itself seems designed to prevent a party from opportunistically taking advantage of another party whose sunk costs would otherwise be lost or not recouped were the trade usage not applied, opportunism does not seem difficult to judge. In some cases, however, particularly where the events are non-verifiable, opportunism may be harder to judge. *See* Cohen, *supra* note 44, at 91 (discussing difficulties of judging opportunistic behavior).

In the plastic widget example one can surmise that the parties omitted the practice of substitution for any one of a number of reasons. First, they may have failed to contemplate the non-availability of red widgets and so made no express provision—an unforeseen contingency. Second, the parties may have omitted to include an express clause opting into all trade practices because there is a subset of trade practices that they might not want legally enforced;¹⁴⁰ they might be reluctant to agree to a general opt-in clause. Yet, presumably the parties would want a court to incorporate the trade practice permitting a substitution of green for red widgets. Otherwise, a party could opportunistically seek to have a term interpreted to mean red with no substitutions in circumstances where doing so might cause the other party to be in breach and allow the advantaged party to seek a cheaper source of widgets, whether red or green.

If a contract contains certain provisions obligating a party to do a certain act in return for a return payment, one party can exercise discretion in a way that will adversely affect the other party (who may have invested sunk costs) unless that discretion is controlled.¹⁴¹ If the court can police opportunism *ex post*, in a cost-effective way, then it should assume an active role.

In many cases courts assume an active role in incorporating trade practices that are specifically designed to curb opportunism. In this set of cases involving the exercise of discretion (described below) the default rule of a “minimum evidentiary base” should not govern interpretation issues. Doing so would permit deadweight losses of opportunistic behavior, a result that would not maximize gains from trade.

The cases described below all involve contracts in which one party ultimately sought to exercise discretion in a way that was not explicitly controlled by contract so all of the contracts were incomplete. In each case the court admitted extrinsic evidence of a trade practice. Doing so

¹⁴⁰ These include cases in which a party wants to retain the discretion whether to adhere to a practice, generally one which waives a strict term, because the decision to adhere or not will depend on information that is readily available to parties but not to courts. See Kostritsky, *supra* note 54, at 459.

¹⁴¹ In some ways the effort of the law to control discretion appears in many junctures in contract law. In bilateral contracts where parties promised to perform reciprocal duties and had not conditioned a duty to perform on the other party being ready, willing and able to perform, the courts invented the doctrine of constructive conditions of exchange in order to prevent one party from opportunistically insisting on performance while withholding his own performance and forcing the other party to extend him credit. See RESTATEMENT (SECOND) OF CONTRACTS § 234 cmt. a; see also Edwin Patterson, *Constructive Conditions in Contracts*, 42 COLUM. L. REV. 903 (1942). Before the doctrine of constructive conditions of exchange, absent an agreement of dependency, parties would remain unprotected against the risk that one party would act opportunistically to demand performance from the other party without performing. That risk would require one party to turn over assets or money to another party who has done nothing to demonstrate a willingness to perform. In devising the fiction of constructive conditions of exchange, courts mitigated that risk and thereby increased joint value for the parties.

helped to curb opportunistic behavior that would otherwise have occurred. If applied to such cases, the default rule proposed by Schwartz and Scott of limited extrinsic evidence would result in uncontrolled opportunistic behavior.

In one case, *Gord Indus. Plastics, Inc. v. Aubrey Manufacturer Inc.*,¹⁴² for example, a party ordered a manufacturer to produce a plastic mold and agreed to buy plastics produced by the mold. The manufacturer incurred considerable expense in manufacturing the mold that could only be recouped by the agreement to buy plastics made from the mold.¹⁴³

There was no express contract provision controlling, by a general or specific clause, discretion on the potential opportunistic behavior by the buyer of the manufactured plastics. This case is typical of many contracts in which parties have difficulty anticipating all of the various contexts in which opportunism might present itself and so detailed provisions controlling for such behavior are expensive to craft. The contract also lacked any generalized clause promising to act in the joint interests of the parties. These general clauses are rarely enacted in part because parties may think that they are too generalized to be enforceable¹⁴⁴ and would be disbelieved or discounted because of the presence of opportunism as a facet of the human condition. Parties might also fear including such clauses because it would require courts to police behavior without sufficient guidance.

A question arose in *Gord* as to whether the buyer could simply remove the mold and manufacture its own plastics without paying the manufacturer anything for the mold. Since the contract was silent on that issue, the court could have insisted on literal enforcement and said that since no contract provision obligated the buyer to pay a fee for the mold, that the court could not impose one. However, such literal interpretation would not have been value maximizing since it would have left the manufacturer subject to uncontrolled opportunistic behavior. The court successfully regulated that behavior by directing the trial court to admit extrinsic evidence of a trade usage that obligated buyers in such cases to pay a mold removal fee.

The admission of the broader evidence in *Gord* and similar cases would increase gains from trade since it served both parties' interests by controlling the general problem of moral hazard (by discouraging a party from appropriating the mold) and thereby opportunistically preventing the party with the sunk engineering costs from recovering the costs through sales over time. Cases involving discretion present a large subset of cases in which restricting a court to the minimum evidentiary base is not appropriate

142 *Gord Indus. Plastics, Inc. v. Aubrey Manuf. Inc.*, 431 N.E.2d 445 (Ill. App. Ct. 1982).

143 *Id.* See also Kostritsky, *supra* note 54, at 502 (discussing *Gord* and similar cases involving irretrievable sunk costs and trade usages designed to police the exploitation of such investments).

144 WILLIAMSON, *supra* note 13, at 63.

and in which admission of the trade usage to interpret the contract will control a contractual risk.¹⁴⁵

In another case, a contract similarly lacked express provisions to control discretion and behavior. The contract required the defendant/lessee to return the leased planes in “their original condition” to the lessor.¹⁴⁶ The court had to consider and interpret the meaning of “their original.” In many contexts a literal reading would suggest that the meaning was one of returning the planes in the same condition that they had been turned over to the defendant. But on the facts, the court found it was error to refuse to admit evidence of context that would put a greater burden on a lessee in this situation. Rather than being obligated merely to return the planes in the same condition, the lessee might be required to overhaul the planes.¹⁴⁷ Without that broader interpretation based on extrinsic evidence, the plaintiff’s massive investment in the sunk cost of the airplane could have been greatly reduced. The court held that it was error for the trial court to exclude such evidence on the assumption that the term in “their original” condition was self-defining.

This airline example illustrates another possible heuristic that courts should use in deciding how broadly or narrowly to interpret a contract. When there are express words in a contract yet there is an aspect of discretion in how one performs an obligation that is the subject of those words, the court should and will be more likely to adopt a broad interpretation if doing so will control discretion that would otherwise be uncontrolled under a formalist approach.

The counterargument to automatic inclusion of broader context in a case like the airplane maintenance case is that if the party wants to impose on the lessee the obligation of maintaining the airplane in a particular way, that he should include a clause in the contract. Absent inclusion, the

145 For example, in *Provident Tradesmens Bank & Trust Co. v. Pemberton*, 24 Pa. D. & C.2d 720 (Common Pleas Court of Philadelphia County 1961), the court had to determine whether the bank that took out an insurance policy on a car had to notify the dealer of the lapse of the policy. Because the contract was silent, the bank that financed the sale, in effect, had discretion on whether and when to notify the dealer that the insurance policy had been cancelled due to a default. The court found that under both a course of dealing and trade usage the bank was required to notify the dealer of the policy default. Thus, even though there was no express requirement of notice, the court “interpreted” the contract to include a notice provision. The court-supplied term would presumably benefit both parties. By regulating the behavior of the bank to act in a way that ignored the interest of the dealer in having early notice “in order to protect [itself],” the court regulated the ability of the bank to prefer its own interests. *Id.* at 726. The intervention could be achieved at a relatively low cost since the usage itself would provide evidence of a private solution of parties to the problem of uncontrolled discretion. Textualism would have provided no solution since the contract was silent on the matter. Self-enforcement through reputational sanctions by dealers who learned of the practice might provide an alternative mechanism of control.

146 *Haeberle v. Tex. Int’l Airlines*, 738 F.2d 1434, 1437 (5th Cir. 1984).

147 *Id.*

counterparty (the lessee) might argue that it assumed that because there was no clause requiring maintenance that would preserve the plane's ability to fly, that no such obligation was being imposed and that the contract was priced accordingly. To permit invocation of the trade usage would arguably allow the lessor to gain an unbargained-for advantage.

The difficulty with the counterargument is that the prevalence and regularity of the trade usage will lead lessors to assume that the trade meaning would prevail. They will reasonably believe that the meaning of the contract "ordinary wear and tear" will be read in the context of trade usages. The parties in the trade won't know that you have to specifically signal that meaning in order for it to govern in the contract. They will assume that trade meaning is ordinary meaning.¹⁴⁸

One difficulty with having a majoritarian ordinary plain meaning govern and excluding extrinsic evidence in cases such as those discussed above is that either there is no term at all to govern (as in the plastic mold manufacture) or the plain meaning will not control the behavior at issue (as in the airplane case). Under Schwartz and Scott's approach unless the parties have generally or specifically opted into the particular trade or private party meaning, ordinary plain majority meaning would govern and context evidence of how differences in the meaning of "original condition" might differ in a standard context from an airplane context would be disallowed. An ordinary meaning approach would not actually solve the need to control discretion in how the planes are serviced and such behavior that, if not controlled, will foster opportunism, increase deadweight loss, and deter contracting *ex ante*.

Literal enforcement of an express term without context evidence could also facilitate opportunism in other scenarios. Imagine a hypothetical case, posed by Aaron Edlin,¹⁴⁹ in which a headhunter is employed by a company that agrees to "pay for any of the headhunter's referrals that the company hires."¹⁵⁰ The language at issue describes some ministerial act, such as paying a fee to a headhunter who supplies resumes and in that sense it is obligatorily complete. The language says nothing, however, about possible ways in which the headhunter could purport to perform an action that would literally entitle it to a payment and in that sense is economically incomplete.

However, the headhunter could, at its discretion, engage in activities that should be considered a breach of the performance obligation despite literally adhering to the terms of the parties' contract. The headhunter,

148 I am grateful to Professor Avery Katz of Columbia University Law School for pointing this out.

149 Comments made by Professor Aaron Edlin, Professor of Law, University of California, Berkeley, at the University of California at the Columbia Conference on Contracts, April 7-8, 2006.

150 *Id.*

instead of culling the resumes and presenting a small number of qualified candidates to the company for the position, could send the company the resumes of all U.S. citizens and the company could eventually hire one of those U.S. citizens.

The question would then arise as to whether the company is obligated to pay the agreed on fee to the headhunter.¹⁵¹ A literal interpretation of the language would suggest that payment of the fee is due. The interpretation issue arises because although the contract is obligatorily complete, it is incomplete in an economic sense. The contract fails to impose any limits on discretion by the headhunter though presumably it would be efficient (though costly) to control such discretion.

A similar issue in which an element of discretion is hidden in a seemingly clear statement of a performance obligation was presented in the famous *Dixon* letter of credit case.¹⁵² The court had to decide whether to admit evidence to interpret a term that obligated the seller to furnish the bank with a “full set” of bills of lading. Because of a delay, the seller could only present one original bill of lading but was willing to supply an indemnity covering the bank for any losses it might sustain in honoring the bill of lading.¹⁵³ Trade practice universally permitted such indemnities but the bank refused to honor the indemnity.¹⁵⁴ The court had to decide whether to admit the trade usage in interpreting a seemingly fixed term of the contract or whether to insist on literal enforcement of a full set to mean a full set.

A hidden aspect of the case and many similar cases is that a party in carrying out its duties may act opportunistically by insisting on literal compliance with the express terms of the contract. That danger can be controlled by the courts if they admit contextual evidence of a trade usage that controls such behavior or discretion by subjecting the contract to a reasonableness interpretation that is different from literal interpretation. The bank had argued that it retained the absolute discretion to reject the proffered indemnity.

In the *Dixon* case the court admitted evidence of the trade usage obligating banks to accept indemnities and rejected the plain meaning interpretation. That trade usage was a private strategy for controlling the potential that a bank would act opportunistically. A bank could seize upon technical non-compliance to shield itself from a risk that it had undertaken—namely that it might be difficult to collect reimbursement from the buyer’s bank if changed circumstances, such as war, adversely affected the buyer’s bank overseas.¹⁵⁵

151 *Id.*

152 *Dixon, Irmaos CIA, Ltda., v. Chase Nat'l Bank of N.Y.*, 144 F.2d 759 (2d Cir. 1944).

153 *Id.*

154 *Id.*

155 See John Honnold, Comment, *Letters of Credit, Custom, Missing Documents, and the Dixon Case*, 53 COLUM. L. REV. 504 (1953).

In these cases (*Dixon* and headhunter case) and in others, literal enforcement of the clause for payment would seem to obligate the company to pay the headhunter a fee and for the bank to insist on a full set of bills of lading. Yet, by admitting evidence of a trade usage or by interpreting the clause using a reasonableness test, the court could control the behavior and discretion that a party might have in performing under the contract. Thus, in cases where the contract is incomplete in controlling behavior, invocation of context evidence can control rather than foster opportunism, especially when the existence of a benchmark trade practice is universally adhered to and there is no reason to think that the usage would not apply in some subcategory of cases (as might be the case where the usage might be a matter of grace rather than right because the applicability might depend on information to which the parties, but not a court, would have access) reduces the judicial error costs with interpreting contracts using such evidence since the violation of a practice designed to deter opportunism would be deemed opportunistic. Even in cases such as the headhunter, when there is no trade practice to serve as a benchmark indicator of what constitutes opportunistic behavior, a court should be able to judge *ex post* that allowing a headhunter to earn payment without doing any of the work that would be expected of a specialist/agent hired to do a task constitutes opportunism. Even if the implicit expectations of an agent are not completely spelled out because of the cost of doing so, and the company is reluctant to put in benchmarks that measure quantitative steps that the agent should perform since they do not capture the issue of effort and quality that the company was seeking,¹⁵⁶ a court should be able to judge *ex post* that assembling resumes without any vetting of those resumes would fall short of the effort expected of an agent for hire.

V. THE CASE FOR A PRESUMPTION IN FAVOR OF ORDINARY MEANING

A separate issue that arises in any contract interpretation is the issue of what language was intended to govern. Schwartz and Scott also disagree with the *Uniform Commercial Code* presumption in favor of the admissibility of extrinsic evidence of trade practices to determine what language governs, the ordinary meaning or the private trade meaning. They posit that the "interpretive issue" about what language governs the contract should be resolved by a presumption that contracts are written in ordinary talk *unless the parties specifically opt into trade language or party talk*.¹⁵⁷ This presumption

¹⁵⁶ John W. Pratt & Richard J. Zeckhauser, *Principals and Agents: An Overview*, in *PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS* 9 (John W. Pratt and Richard J. Zeckhauser eds., 1985).

¹⁵⁷ Schwartz & Scott, *supra* note 21, at 573, 584. That interpretive issue would be resolved using no outside evidence. Instead, the court would look only to the parties' express declaration in deciding on the language issue. Silence would indicate a preference for majority

would constitute the preferred “linguistic default” that would govern the interpretive issue of what language governs a contract,¹⁵⁸ making extrinsic evidence superfluous.

The interpretive issue of what language governs is closely connected with the issue of how broadly the court should expand the base of extrinsic evidence. If courts were to follow the textualists’ approach, then unless the parties opted into trade meaning, ordinary majority talk meaning would govern and courts would not admit contextual evidence on the language meant to govern the contract.

To address these interpretive challenges and to decide if a presumption of ordinary meaning is optimal, we need a methodology that is attentive to the reasons why the interpretive problem arose, i.e., why parties might fail to expressly reject ordinary majority talk in their contracts, and opt into trade meaning as the interpretive default.

This article argues that because the interpretive presumption against trade language and in favor of ordinary meaning will not always maximize gains from trade for the parties (the accepted goal of private contracting), and is likely to facilitate opportunism in many cases, it should not be adopted. This article’s basic objection is that the textualists assume that language selection is a matter that parties can deal with *ex ante* as a stand alone issue, apart from the functional goals that the parties hope to achieve. But whether a court is interpreting what language governs the contract or deciding the appropriate width of the extrinsic base of evidence, the methodology the court uses should remain the same and should not be artificially separated from a normative theory that will allow the court to reach a value maximizing result for the parties. Nor can one isolate the interpretive question of language selection from the context of the problem that the contractual language was crafted to solve or the transactions costs associated with crafting solutions to the problems the parties face.

The problem with the textualists’ isolation of the language question from the normative issues in contract interpretation is that unless parties have opted out of ordinary meaning, it will govern in cases where it will simply not be value maximizing. Ordinary meaning would govern outcomes such as the headhunter case, and would not solve the opportunism problem that would occur if headhunters could insist on “ordinary meaning” and avoid any need to undertake the onerous task of actually culling the resumes of applicants.

There are several arguments put forth by the new textualists in favor of an ordinary language linguistic default. First, the suggestion is that the burden on parties who want trade meaning to govern is low since parties may easily opt out of the default presumption in favor of ordinary

talk.

158 *Id.* at 584–85.

meaning¹⁵⁹ by simply subscribing to a clause that trade meaning governs.¹⁶⁰ This ignores the fact that there is a spectrum of trade practices. Parties may wish to retain certain trade usages or practices to inform the language issue, while opting out of others. Thus a one size fits all rule enshrining ordinary meaning as the interpretive default may not serve the functional needs of the parties or maximize value. A more tailored method to incorporation and thus to interpretation utilizing a taxonomy of factors or heuristics would improve decisions regarding when trade meaning should be admitted for interpretation to produce welfare gains.

Requiring the parties to expressly incorporate trade usages and practices to have them govern a contract is premised on assumptions about the effects that the announced rule—no trade practices if not expressly written into the contract—will have on parties negotiating future contracts *ex ante*. The implicit assumption is that parties will thereby be induced to always draft express terms incorporating the trade usage and thereby save on error and misinterpretation costs in the future.

The presumed effect of a default rule denying effect to trade meaning unless expressly incorporated is that it will cause parties to reform in the future. They will expressly incorporate those trade practices that they want to govern meaning, but that projected reaction to the announced legal rule may not occur in all instances. That failure suggests that there may be unanticipated costs from the insistence on express inclusion. In some instances the announced rule will cause parties to opt for express inclusion, particularly where a trade association exists to police the uniformity of the documents and to spread the start up costs of drafting. But cost barriers may prevent a large segment of the affected population from even knowing the rule and adjusting their behavior in accordance with the rule. In those instances insistence of a rule denying effect to trade usages not expressly incorporated would mean that many of the usages designed to control opportunistic behavior would be ignored and the consequence would be an increase in opportunistic behavior creating a drag on gains from trade. Moreover, because many parties are likely to assume that trade meaning is ordinary meaning, they won't know that one has to specifically signal trade meaning in order to have it govern the contract. Because of the assumption that trade meaning will govern and because parties won't even know enough to discern when they are using trade meaning and when they are using a word with only an ordinary but no trade meaning, forcing parties to specifically opt into trade meaning will impose translation costs.¹⁶¹ The reliance on trade meaning is so ingrained that it will be assumed to be part

159 The opt out of the default presumption could be handled by a general clause. Schwartz and Scott suggest the following: "This agreement is to be read in light of the customs of the widget trade." *Id.*

160 *Id.*

161 See Kraus & Walt, *supra* note 127, at 199 (discussing these "translation costs").

of every contract. For that reason, a party who is going to insist on a non-trade meaning ought to have to signal that deviation so that the other party can price the contract accordingly (i.e. on the basis of ordinary, non-trade meaning).

Another problem with the announced rule of no trade practices unless expressly incorporated is that the express terms of the trade practice once they were in the contract would themselves have to be interpreted. Insistence on express language may not be a panacea for avoiding judicial errors, so the guiding principle should be to interpret language or add terms in ways that parties would have subscribed to in order to maximize joint gains.

The presumption in favor of ordinary language and in favor of express incorporation also ignores the specification costs involved when parties accustomed to using trade language are required to translate all of their assumptions and meanings into ordinary language.¹⁶² The argument that since “a minority of contracts are written largely in private languages . . . fewer parties would have to contract out of a default that supposed them to be written in majority talk.”¹⁶³ However, it is more likely the case that contracts are written neither wholly in private/trade language or ordinary talk but in a combination of these languages. Thus, arguably a large number would be burdened by having to opt out of the linguistic default in order to have any trade meaning govern. Once one realizes that parties contract implicitly assuming that trade meanings will govern when they are needed to achieve parties’ instrumental goals, then insisting on ordinary meaning is not likely to maximize gains from trade.

This article posits another objection to ordinary meaning as the linguistic default. Connected to this objection is the notion that parties cannot agree on a language selection *ex ante* apart from the normative choices about which language or meaning will serve their instrumental goals in various contexts. A presumption in favor of ordinary meaning would, contrary to the assertions of Schwartz and Scott, facilitate rather than contain opportunism in many instances and a court should be sensitive to that fact in determining what language governs.¹⁶⁴ The next section will attempt to demonstrate how and when this is likely to occur.

¹⁶² See *id.*

¹⁶³ Schwartz & Scott, *supra* note 21 at 585.

¹⁶⁴ One example of how a literal adherence to a textual meaning could facilitate opportunistic behavior is *Cutter Laboratories Inc. v. Twining*, 34 Cal. Rptr. 317 (Cal. Dist. Ct. App. 1963). In *Cutter* the court had construed a contract term of “1800 shares” to determine if those shares also included the shares acquired through later division of those shares through a split or dividend. In the original agreement Twining had placed one-half of his shares (1800) of the company in escrow. The escrow agreement obligated the company to maintain a life insurance policy on his life, the proceeds of which would be paid to his wife at his death; in exchange the company would receive the 1800 shares of Twining’s stock. Subsequently, Twining was given the opportunity to rescind the original agreement which had become increasingly unfavorable

Schwartz and Scott argue that in any contracting situation parties have a choice whether to draft in the majority language of ordinary meaning or in the private language of the trade. An alleged benefit of their proposed linguistic default is that it will encourage parties to draft contracts in majority language.¹⁶⁵ But encouraging parties to use majoritarian, ordinary meanings unless they specifically opt into trade meaning will not result in complete contracts and many interpretation questions will remain. The question should be whether encouraging parties to draft in majority language (ordinary English) will solve their problems in a cost-effective way. Schwartz and Scott believe that the use of majority language will reduce strategic behavior. They argue that a majoritarian default rule will reduce the possibility that parties will later claim a private trade meaning for opportunistic or strategic reasons.¹⁶⁶ Unless the parties have clearly opted into the private trade meaning *ex ante* they will not be able to strategically invoke a “fictional” private trade meaning later on and will be bound by the majority meaning.¹⁶⁷ However, this claimed advantage may not hold up in a broad array of cases. Since there are huge transaction costs of forcing parties to translate all of the meaning into a language they do not even think in, law should not favor one over the other. Instead, the instrumental advantages of joint maximization should determine which meaning governs.

to him and favorable to the company since the stock had appreciated in value and the capital asset far outweighed the face amount of the life insurance policy. The court considered a variety of evidence to construe the term 1800 shares, including recognition that Twining had desired to shelter one-half of his assets from any risks that would be associated with stock ownership in return for a fixed asset, an insurance policy, that carried no risk of decline.

When Twining’s son tried to rescind the agreement, the court enforced the agreement and construed the term “1800 shares” to include later acquired shares arising from the stock splits. In the case, the court reached its interpretation by using course of performance evidence to show that the parties themselves interpreted the disputed term in that manner. The use of such extrinsic evidence effectively curbed opportunistic behavior in a way that could not be achieved by insisting on a textual meaning that 1800 shares meant 1800 shares. The text did not answer the question of what was included in the term.

165 Schwartz & Scott, *supra* note 21, at 572.

166 Schwartz and Scott are assuming it would be more efficient to force a meeting of the minds on this issue *ex ante* rather than punt to the courts. This is unlike the case where the parties didn’t specify a trade usage because they simply didn’t recognize their own use of private talk (for example “everyone in our industry knows this is an estimate . . . we didn’t think we had to spell it out . . .”), this seems like a simple failure of the parties to negotiate their way to a solution. In cases like that, a penalty default rule that lets one party chisel another could be more efficient if it saves more in litigation costs than it forces the parties to spend in negotiations. However, this article argues that the instrumental advantages should be paramount rather than the goal of forcing the parties *ex ante* to opt into language whose implications they may or may not be aware of.

167 *Id.* at 586. The ability of parties to invoke a fictional meaning seems inexplicable to Professor Bowers who asserts: “it becomes a mystery why parties might ever invent and use ‘party talk’” given the preference for ordinary meaning. Bowers, *supra* note 88, at 608.

Schwartz and Scott argue that because there can be multiple private trade meanings that parties may invoke after the fact, parties should be forced to signal to the court *ex ante* that they want those private meanings to govern.¹⁶⁸ Forcing parties to opt into private trade meanings beforehand lessens the chance that a party whose deal has gone bad will attempt to invoke a private meaning as a way of escaping its obligations.¹⁶⁹

The example that Schwartz and Scott use to demonstrate the potential opportunism that comes from permitting private trade meaning derives from two examples. The first is one based on a contract that uses the language “red,” but a party later claims a private meaning of “green.” The difficulty with permitting the invocation of the word green would send the court on the wrong quest; the court would “be attempting to find the correct shade of green while the parties, *ex ante*, wanted a court to find the correct shade of red.”¹⁷⁰

The red/green example seems to deviate from real life situations in ways that suggest the example may not be representative of the problems that parties face in drafting contracts or that courts face in construing them. In real life situations invocation of trade meaning will not be opportunistic, at least not across the board. The invocation of the private meaning of “red” to mean green seems to have no functional basis, but seems instead a merely arbitrary invocation of a meaning that is completely divergent from the literal text, leaving open the suggestion that one party may attempt to exploit it for opportunistic reasons.

By contrast, in many cases, there is a trade usage that does not arbitrarily assign a different meaning to the literal text. Instead, the trade usage might suggest that a certain percentage tolerance or shortfall might be permitted in every delivery of a certain product and that tolerance should be used to interpret, broadly, the literal term. The usage may have developed because it may be difficult and costly to produce goods in the exact quantity specified. The development of a trade usage allowing a certain deviation of a small percentage would prevent one party from perhaps opportunistically claiming that a minor deviation amounted to a total breach. The usage would permit small deviations within a range to be tolerable and would not impair performance.¹⁷¹ At the same time, any nonperformance not within the usage would be considered a breach. In these cases the party insisting on literal compliance is the one who seems to be acting opportunistically¹⁷²

168 Schwartz & Scott, *supra* note 21, at 586.

169 *Id.*

170 *Id.* at 587.

171 See e.g. *Ambassador Steel v. Ewald Steel Co.*, 190 N.W.2d 275, 277 (Mich. Ct. App. 1971) (permitting “steel with a carbon content of 1010 to 1020”).

172 In some cases the party insisting on a literal interpretation and the exclusion of extrinsic evidence may be a third party with a vested interest in getting the court to adopt a plain meaning interpretation that diverges from the intended meaning of both parties simply

and trying to avoid the burden of a trade usage that he was fully aware of and that both parties presumed would govern the parties' obligations. Contextualized interpretation of language as trade language would help to avert such results.

The other example used by Schwartz and Scott to illustrate how permitting the invocation of private meaning will foster strategic behavior is one in which parties invoke trade meanings after the fact to claim that fixed quantities of goods are merely "estimates".¹⁷³ That claim is often manufactured by a party to "rescue itself from a bad deal."¹⁷⁴ By requiring a party to decide beforehand whether the quantity is an estimate and to invoke that trade meaning and to secure the other party's acquiescence to that private meaning, Schwartz and Scott argue that misunderstandings and opportunism can be averted.¹⁷⁵

Forcing the parties to opt into a private trade meaning that a "fixed" quantity case really means "flexible" amount beforehand could avert opportunism. However, setting the suggested linguistic default rule at ordinary meaning is apt to allow many parties to opportunistically escape the burden of a trade usage that all assumed would govern. The real problem with the "fixed quantity" means "flexible quantity" issue is that there seems to be no limit on the discretion afforded the party setting the quantity. For that reason, it is unlikely that even if parties had had a difficult time setting a firm quantity in the contract, because of uncertainty, they would both have agreed to afford unlimited discretion to one party to set any quantity as a solution to the uncertainty problem. Thus, the problem is not with all trade usages and private meanings per se but with the particular type of usage that affords unlimited flexibility and invites opportunism. Without limits on that discretion, it would seem unlikely that the court's incorporation of the private meaning of "flexible quantity" would be value maximizing. It would be difficult for the court to conclude that the practice was one designed to curb opportunism and to judge after

to secure an advantage. Such was the case in *Sunbury Textile Mills, Inc. v. IRS*, 585 F.2d 1190 (3d Cir. 1978). In that case the IRS attempted to persuade the court to adopt a plain meaning of the word "cancel" that neither party intended in order to deny one company an investment tax credit that would otherwise be available under the meaning both parties clearly intended. The court refused to adopt the plain or dictionary meaning when it diverged from meaning shared by both parties. The decision is consistent with other decisions in which courts reject plain meaning when doing so prevents a party, in this case the IRS, from gaining a windfall. Doing so would deter a party, such as the IRS, from proffering meanings simply to increase tax revenues to the government.

¹⁷³ Schwartz & Scott, *supra* note 21, at 586.

¹⁷⁴ *Id.* This is based on the *Columbia Nitrogen* case. See *infra* note 175.

¹⁷⁵ Their paradigm case is based on a series of cases in which the court had to decide whether a stated quantity was not in fact that quantity but a lesser amount because the use of a term with a stated quantity was meant to afford the buyer flexibility. See, e.g., *Columbia Nitrogen Corp. v. Royster Co.*, 451 F.2d 3 (4th Cir. 1971).

the fact that opportunism had in fact occurred. For that reason, unless the reasons for a deviation from a quantity are spelled out or outlined in a clear usage, the court should be more wary about intervening to interpret the quantity term in a broad fashion because it is hard to see how judicial intervention by incorporation of the “flexibility” usage would advance the parties’ goals.

In many cases, however, trade usages and practices should govern. Requiring parties, however, to opt into such usages *ex ante*—the textualists’ suggestion to opting out of the ordinary meaning default—will present problems. Because the range of contextual evidence currently includes a broad spectrum of proof including course of performance, course of dealing and usage of trade and because the parties may have different preferences on admissibility corresponding with different types of context evidence, parties might be reluctant to opt into all types of context evidence even if they want *some* types of trade practices to govern. Thus, determining what types of context evidence to include and what types to exclude, would force parties to incur large specification costs.

In addition, even if parties are given the option of opting into trade practices that constrain such behavior, they may be reluctant to do so because in some instances they may not want them to govern contract interpretation. The consequence of failing to opt into all trade meanings under the Schwartz and Scott approach is that the parties are bound by general ordinary meaning. However, insistence on a generalized ordinary meaning may facilitate opportunistic behavior which is something parties *ex ante* would want to control. The majoritarian linguistic default rule will fail to control the discretion of the parties. If a majoritarian linguistic default leaves the parties’ discretion unconstrained, it will foster opportunism, increase deadweight losses, and deter contracting *ex ante*.

An example of opportunistic behavior that would be facilitated by a majoritarian default would be where there is clearly a private trade meaning that all parties in the industry are familiar with and which they would therefore presume to be part of any contract. After the contract is entered into, one party insists on an ordinary non-trade meaning as a means

of gaining a private advantage that was not bargained for. For example, if everyone in the trade adheres to a custom in which 49.5% is treated as equivalent to 50%, a party arguing that 49.5% is a breach under the literal ordinary meaning of 50% or would entitle them to a lower price would be seeking to acquire an unbargained-for advantage.¹⁷⁶

These two contrasting examples, one in which literal meaning can foster opportunism (interpreting 50% as 50%), and one in which a trade meaning could foster opportunism (70,000 means a flexible quantity), suggest that the appropriate approach is not to bar all trade meanings unless they are specifically invoked because this approach would foster opportunism in many cases. One must recognize that there are many types of trade usages and business practices. Because of transaction costs, it may be difficult for parties to identify all of the specific trade usages and practices that may be relevant. This prevents parties from efficiently opting into specific trade practices.

At the same time, opting into the entire range of custom and course of dealing and trade practice as the only way to avoid the majority non-trade meaning would be problematic for parties because there are some instances in which the parties might not want the court to enforce a practice but might instead prefer a plain meaning approach. This is most likely to be the case when the parties want to adhere to or reject a course of dealing or course of performance based on information that might be available to the parties but not readily available to courts. Instances such as this occur in cases where parties agree on the sale of a fixed quantity of goods, and one party later argues that there is a trade usage, or history of dealing between the parties which suggests that the quantity terms are flexible. In these cases, one party will waive adherence to the literal terms of the contract and allow the other party to buy or sell a lesser amount of goods. Parties may be hesitant to opt into or out of such trade usages in the face of an "all or nothing" approach, because whether or not they want the trade usage enforced will depend on a variety of factors which are unknown *ex ante*. Such factors include whether or not the party seeking to invoke the trade usage is acting opportunistically, and whether making a concession is likely

¹⁷⁶ See, e.g., *Hurst v. J.W. Lake & Co.*, 16 P.2d 627, 629 (Or. 1932). The marginal benefit in quality of the horsemeat from 49.5% to 50% is not worth the cost that the producer would have to take to ensure that the meat was always at least 50% protein, so the system builds in a little tolerance for error. If this trade usage were not in effect, horsemeat would probably be a lot more expensive, as the producer would have to spend a lot more on monitoring costs to ensure that his product would not be rejected by the consumer.

One would probably expect to see this issue to arise a lot in transactions involving high volumes of low cost goods (nails, screws, cement, feed, sand, and various grains and so forth). With each of these goods the costs of ensuring complete compliance with a customer's specifications will likely outweigh the gains from producing them (since these are probably goods produced with a very low profit margin to begin with).

to generate enough repeat business to be cost justified. These matters seem to be particularly difficult for a court to judge¹⁷⁷ and therefore there might be reason to insist on literalism as the best way of avoiding judicial errors. This factor would suggest literalism would be the better approach in the “flexible” quantity cases.

Another problem with the default rule of ordinary meaning is that it suggests that unless parties have opted into a specialized meaning beforehand, it will not govern. Yet, there are many cases where the evidence of a private meaning is clear, adoption of the private meaning will best achieve the parties’ goals, and permitting the private meaning to come in will not pose large unverifiable claims for the court or advance party opportunism.

In *In re Soper’s Estate*,¹⁷⁸ the court was confronted with a vexing interpretive language question involving the meaning of the word “wife.” Under the terms of the relevant insurance policy, the proceeds were to be paid to the decedent’s wife. After payment was made, it was discovered that the only lawful wife was not the person with whom the decedent had been living but instead his first wife whom he had abandoned under circumstances suggesting suicide.¹⁷⁹

The legal wife challenged the payment to the non-wife. Under a plain meaning approach the legal wife would have prevailed on the theory that “wife” has only one meaning in a dictionary sense.¹⁸⁰ This result would have contravened the decedent’s clear intention and the only parties to the contract were unaware that another legal wife actually existed.¹⁸¹

177 They would be unverifiable.

178 *In re Soper’s Estate*, 264 N.W. 427 (Minn. 1935).

179 *Id.* at 429.

180 *Id.* at 431.

181 A similar result was reached in a case when a court had to construe the meaning of the words “legal heirs” in a will. Although technically and literally, the word “legal heir” would include the wife, the court refused to construe the will in that manner. Instead, it indicated that the construction should follow the testator’s intent which the court concluded was to exclude the wife as a residuary devise. The court rationalized the result by citing case law that provided that “though their technical significance is not to be overlooked, [such words] may, to give effect to the testator’s intent, be held to refer to others than those who are technically heirs.” *In re Anderson’s Estate*, 180 N.W. 1019, 1020 (Minn. 1921). There would seem little danger that the collective good of words having a stock meaning that parties can rely on will be significantly jeopardized. Parties will continue to rely on legal heirs to have a certain meaning but will also realize that when the drafter has manifested clearly an alternate meaning, that meaning will govern, just as it did in the *In re Soper* case. If the court had overlooked the testator’s intention and imposed a meaning at odds with that intention, there would be a much greater negative effect on parties planning transactions. If a party has a clear intention that is at odds with the objective or technical meaning, the court should honor that intention because it can do so without causing most parties to ignore the technical meaning. That will still continue to govern in the vast majority of cases.

In cases like *Soper*, where no party is misled, and the evidence of a private meaning is clear to everyone who was a party to the contract, the burden on the court of judging the parties' intentions is low.¹⁸² In addition, there is no reason to believe that insistence on a private meaning is fictional or would otherwise promote opportunistic behavior, and there is no reason to believe that insistence on plain meaning will provide an incentive for developing a stock of default terms that parties can rely on in future contracts that would not otherwise be available.¹⁸³ In short, given the low cost of ascertaining the parties' intentions, there would seem to be no reason to insist on plain meaning.¹⁸⁴

The textualists would argue that the danger of permitting an idiosyncratic meaning is that it deprives future parties of autonomy "who subsequently use the term wife to refer to the person to whom they are legally married."¹⁸⁵

Yet, it would seem that in most cases where a husband has abandoned a wife and been living apart for a great length of time in circumstances suggesting suicide, he would want the woman with whom he was living currently to benefit. Determining the parties' actual meaning "involves the greatest benefits" as an interpretive strategy¹⁸⁶ because it allows the court to determine the actual meaning. Because in the *Soper* case the

182 This invocation of a specialized private meaning known to the two parties who were involved in the contract, the insurance company and the partners in the business, is akin to courts relying on evidence of a secret code that is not contested by parties to the contract. See CORBIN ON CONTRACTS § 24.8 at 56 (indicating that "both Judge Easterbrook and Judge Posner. . . have recognized that courts will enforce secret meanings to which the contracting parties have mutually assented").

183 Goetz & Scott, *supra* note 17, at 316 (discussing value of adherence to plain meaning in increasing "the supply of officially recognized invocations . . .") Once parties invoke an idiosyncratic, non-standard meaning and the court allows the admissibility of evidence of that non-standard meaning, then all parties in the future are disadvantaged because they are no longer able to count on a court giving effect to the standard, plain meaning of the word "wife," for example. The court often insists on adherence to plain meaning where one party is insisting on a private, unmanifested intention that diverges from the objective plain meaning of a word or term of a contract. The court insists on plain meaning in part to prevent the great uncertainty that would arise if parties could plead private intentions that were not obvious to the other party. In the *Soper* case, allowing one party to plead that his private intention diverges from the plain meaning does not disadvantage a party who relied on the objective plain meaning.

184 The argument that interpreting the word wife to refer to the non-legal wife will "diminish the autonomy of all contractors who subsequently use the word 'wife' to refer to the woman to whom they are legally married," KRAUS & SCOTT, *supra* note 38, at 656, seems inapt since courts would have no reason to depart from the ordinary plain meaning of the word "wife" unless the evidence were clear that a different meaning were intended. Thus, in the vast majority of cases, courts will have no reason to depart from the ordinary meaning.

185 *Id.* Public policy concerns might dictate an overturning of the contractual choice despite the interpretation to mean the non-legal wife.

186 Posner, *supra* note 3, at 1590.

evidence of the intended meaning was overwhelmingly clear, and there would be low costs associated with courts giving effect to such intention in that case, the court should give effect to what the parties actually meant.¹⁸⁷ For the vast majority of parties, who are living with and legally married to their spouses, the designation of the word wife in a legal document will pose no interpretive problems and cause no uncertainty nor increase the unpredictability of all common words in contract. Parties can continue to rely on the word wife to connote legal wife. However, requiring all parties to abide by that meaning sets up the possibility that a non-advantaged, non-intended party would be given an opportunistic windfall and the only advantage for future parties would be to make available the stock of words having an ordinary meaning (“wife”) when in fact the stock of such words with ordinary meaning is already available to all parties.

The other problem with adopting an ordinary meaning interpretation is that it could foster opportunism in many types of cases that do not involve a term of art but a phrase describing a party’s performance obligation. Because these descriptions are inevitably incomplete, a linguistic default in favor of “ordinary” meaning will result in the court interpreting each word literally, but in a way that does not and cannot solve the real problem of how to control opportunistic behavior. Thus, in all instances in which contracts are incomplete in failing to control behavior, a linguistic default of ordinary meaning will be a misguided one that will not maximize gains from trade.

Often the parties face uncertainty about each other’s propensity for opportunism. One party inevitably may have discretion about how to act under a contract because that party will have to make choices during the performance of the contract. Often nothing will be said in the contract that specifically controls that behavior and discretion. Yet, courts routinely admit trade usages when they have been developed to curb opportunism and when costs of enforcing such usage are low because the judicial ability to judge and verify the opportunism is easy. Thus, courts confronting the interpretive issue of what language governs should not adopt a linguistic default of ordinary meaning. Instead, a certain taxonomy of factors should be part of the decision of what interpretive rules should govern the interpretive process and whether courts should incorporate trade usages as a means of curbing opportunism both in deciding what language governs and in deciding how much extrinsic evidence to admit.

¹⁸⁷ In fact, as Professor Chirelstein points out, the Restatement (Second) of Contracts § 201(1) approach would be consistent with the *Soper* result. Where both parties clearly intend a certain meaning, the Restatement indicates that the private meaning should prevail even if it is at odds with the ordinary meaning of the word. See CHIRELSTEIN, *supra* note 40, at 94.

VI. METHODOLOGY

A theory of interpretation of contracts must first address questions of incompleteness. Incompleteness makes an interpretive approach built on a minimum evidentiary base problematic. In fact, if one analyzes the different kinds of extrinsic evidence, it becomes clear that the incorporation of certain types of evidence for interpretation would reduce rather than increase the moral hazard problem, while simultaneously minimizing error costs. This is especially true with respect to certain types of trade usages that are specifically designed to control opportunistic behavior, or create terms of art within a particular industry. If a contract is economically incomplete and it can be shown that the cost of judicial incorporation of non-express terms, either terms of art, objective reasonableness limitations on meaning, or trade practices designed to control opportunism into the contract is less costly than the private strategies for overcoming these barriers, the extrinsic evidence should be admitted.¹⁸⁸ If legal intervention admitting the extrinsic evidence under a default rule incorporating trade usages would accord with the parties' objectives, and there is a large social cost in excluding the evidence, the law should intervene and admit the evidence. The social costs courts should consider in making their decision include whether failure to admit extrinsic evidence would lead to an increase in opportunism and a concomitant decrease in contracting, whether such failure would increase the transaction costs of screening and drafting contracts, and whether other private devices to control behavior (such as reputational sanctions) are more costly or ineffective. Doing so would help to achieve the goals of controlling moral hazard while minimizing the costs of such control.

This approach is consistent with Coase's admonition that "[t]he existence of transaction costs will lead those who wish to trade to engage in practices which bring about a reduction of transaction costs whenever the loss suffered in other ways from the adoption of those practices is less than the transaction costs saved."¹⁸⁹ Translated, this means that if there will be costs associated with uncontrolled moral hazard or opportunism (a type of transaction cost), then parties who want to reduce such costs as a goal will adopt certain practices to control such costs when those costs (including judicial error costs from a more active interpretive methodology) are less than the losses that would otherwise accrue from uncontrolled opportunism.

Professor Ronald Coffey then extends Coase's analysis to cover cases where there are conditions that might make it costly for the parties to control

¹⁸⁸ See Kostritsky, *supra* note 102, at 654.

¹⁸⁹ RONALD COASE, *THE FIRM, THE MARKET AND THE LAW* 7 (1990).

the hazard problems because of a “budget constraint”¹⁹⁰ and provides a model for analyzing when one can be certain that a legal intervention that would apply to the interpretive issue of whether incorporation of a default rule should incorporate trade practices might provide positive net benefits and improve welfare for the parties themselves and society. Such a model would ask “(1) why the parties would be expected to get to that point (a model that makes assumptions about what objectives of parties are and how persons go about seeking those objectives, on average) and (2) why they did not get there (a model that makes certain assumptions about barriers, conjectured noninterventionist ways of surmounting those barriers [private devices], the costs of using each type of surmounting mechanism, and a conclusion that the costs exceeded the expected benefits.”¹⁹¹

Under this model, one might argue that the goals of contract interpretation are larger than the goal of “creat[ing] a contract that a court will interpret in a predictable way.”¹⁹² Instead, the goal of the parties is to achieve their goal of maximizing joint gain while minimizing transaction costs. In some instances, where the parties operate on the basis of private assumptions that create a private meaning and a reluctance to disclose one’s status as a bigamist, but one’s intentions were clear that the word wife meant the non-legal wife, one can argue that forcing the party with the unusual marriage status to use plain meaning in a dictionary sense would defeat the parties’ intentions, a great cost, without significantly increasing the predictability of common words in the future. Instead one can surmise only that if the intentions of all parties to the contract were clear, no one was misled as to who was intended, the court will permit a private meaning to govern. Parties who want their legal wives to take property will not have to work very hard to have the court recognize their entitlement given the ordinary meaning of wife.

If one can determine that these conditions for intervention are met, that the parties did not achieve a contract that expressly controlled all behavioral opportunism, that certain obstacles including uncertainty about future behavior might interfere with contractual solutions, that the parties would seek to reduce that risk as a means of maximizing gains from trade, that reputational sanctions might fail, that private alternative means of controlling opportunism such as pre-screening for opportunism or seeking bonds to cover post-contract chiseling are costly, then a broad interpretive judicial approach might be a superior way of controlling opportunism while minimizing the burden on parties of negotiating individual arrangements to control such behavior.

190 E-mail from Ronald J. Coffey, Professor of Law, Case Western Reserve University, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University (July 16, 1996, 13:37 EST) (on file with author).

191 *Id.*

192 Goetz & Scott, *supra* note 17, at 301.

A Willistonian approach limiting extrinsic evidence, what Schwartz and Scott refer to as the truncated evidentiary base, may still continue to be appropriate in certain cases, particularly where the parties choose to refrain from expressly incorporating a practice for certain reasons. If they omit the practice in order to retain the flexibility to adhere to, or deviate from, a practice depending on information that will (1) only be available later on, and (2) may be difficult for a court to verify, then a court should be wary about admitting the evidence.¹⁹³ These cases often involve a class in which one party waives insistence on adherence to the strict terms of a contract and the benefited party then seeks to bind the acquiescing party to a contractual charge that is binding in all future cases.

These cases typify the paradigm case that prompted the Schwartz and Scott criticism of broad interpretive methodologies. Yet there are reasons why the waiver cases (waiving a fixed quantity term and making it flexible in light of trade practice) should not be grounds for broad interpretation.

First, where the usage takes the form of an accommodation, the parties may have omitted the practice from the contract because they want to await further information and that information might be more readily accessible to the parties than to a court. Courts also seem to be hesitant to enforce trade usages when it appears as though doing so will simply shift the potential for one-sided opportunism from one party to another, and do nothing to eliminate it.¹⁹⁴

However, the Willistonian approach should not constitute the general default rule for all interpretation questions in contract law since there are many types of cases in which admitting extrinsic evidence will be the best and perhaps the lowest cost means to constrain opportunism and prevent a deadweight loss.¹⁹⁵

Professor Ben-Shahar has raised other arguments against the "erosion" rules that result when courts interpret a party's tolerance of a one time breach or waiver as creating a new rule that will waive future breaches and make insistence on adherence to the stipulated performance problematic. This effect will lead parties to insist on stricter adherence to the express obligations, an effect known as the "rigidity effect."¹⁹⁶ However, he finds that the substantive rules on erosion may not matter under certain conditions since there will be offsetting effects that the law permits.¹⁹⁷ This article is suggesting that the reason parties may have omitted expressly incorporating

193 Kostritsky, *supra* note 54, at 459.

194 *Id.* at 508.

195 ELLICKSON, *supra* note 22, at 172-173.

196 Omri Ben-Shahar, *The Tentative Case Against Flexibility in Commercial Law*, 66 U. CHI. L. REV. 781, 784 (1999).

197 Under conditions of imperfect information and monitoring and costly enforcement, an erosion rule of the Code will make parties worse off. *Id.* at 809-812.

these types of practices into an express contract may suggest caution in using these practices to interpret meaning.

VII. HEURISTICS

In this penultimate section I suggest a series of heuristics that are derived from a close examination of a large number of interpretation cases. I am sensitive to the fact that others before me, Professors Craswell, Hermalin and Katz¹⁹⁸ have suggested their own heuristics. This article's suggested heuristics may help to shape the debate about when textualist and when formalist interpretation will achieve the parties' goals including the goals of curbing opportunism and achieving other goals.

(1) Whether a judicial interpretation for one party would foster counter-opportunism by the other party. *Columbia Nitrogen* is a good example of a fact pattern in which admission of evidence of the flexible quantity trade usage would possibly promote counter-opportunism. If the court were to allow the defendant to offer evidence that a fixed quantity actually meant a flexible quantity,¹⁹⁹ that usage would give one party the discretion to order more or less depending on which action would be more advantageous given the price, which would subject the other party to strategic behavior.²⁰⁰ Courts do and should strive to avoid an interpretation that will foster counter-opportunism.

(2) The transaction costs of controlling the matter through express contracting. If the matter, such as the one involving behavioral opportunism under conditions of uncertainty, is resistant to a contractual solution, the absence of an express term does not signal that the parties would not want the court to intervene. Rather, it may indicate that cost barriers prevented the parties from negotiating an optimal solution *ex ante*, leaving the question of whether the court could improve welfare by intervening. That may depend in part on assessing whether the parties could solve the

198 See *supra* note 31.

199 The court admitted such evidence in *Columbia Nitrogen* on appeal. See *supra* note 175.

200 Div. of Triple T Serv. v. Mobil Oil Corp., 304 N.Y.S.2d 191 (Sup. Ct. Westchester County 1969) is another example of a possible favorable decision promoting counter-opportunism. In *Triple T* the contract terms permitted termination of a dealer contract on 90 days notice. The plaintiff wanted the court to interpret that provision to forbid termination except for cause on the basis of trade practices. If the court interpreted the contract by admitting such evidence, it might simply shift the potential for opportunism from one party (the dealer) to another party (the franchisee). That is because the party seeking to rely on custom and usage might subject the franchisor to a risk that it did not bargain for, namely the risk of the court judging on non-verifiable matters, such as whether there was cause for termination.

problem at low cost *ex post* with a renegotiation.²⁰¹ When one party has invested sunk costs, for example, the problem of hold up may interfere with *ex post* renegotiation, at least in the sense that the hold up problem will act as a disincentive for parties to make investments and so will have negative efficiency consequences. The vulnerability to hold up may make *ex post* renegotiation impossible. When *ex ante* and *ex post* solutions are difficult, a court should consider intervening after an assessment of other non-court solutions. Courts should also carefully assess whether the parties have other alternative informal mechanisms outside of contract to control the opportunism problem either through bonding, screening, or reputational sanctions. The court must consider the cost of private strategies that would have to be entered into with each successive transaction to control opportunism and weigh those aggregate costs against the court's intervention to police opportunism on an occasional basis through active interpretive methods.

(3) and (4) The nature of the trade practice and the burden on the court. The nature of the practice itself may provide some indication of whether the court should use it to interpret the contract. In some cases, as in a trade usage which treats 49.5% as equal to 50% or a baker's dozen as equal to 13, the trade usage itself is not one that applies only in a narrow subset of cases nor would it be hard for a court to judge when the usage applies and to what contexts. It is simply an on/off determination.²⁰² If the usage exists and is a term of art, one party's insistence on a contrary plain meaning is likely to indicate opportunistic behavior and a desire to escape from a meaning that both parties were aware of and assumed would govern contractual obligations. Courts strive to avoid this result by interpreting contracts in light of trade usages, particularly those that do not require complex determinations by a court,²⁰³ and in doing so curb opportunistic behavior by parties insisting on plain meaning to avoid contractually assumed risks.

201 Katz, *supra* note 9, at 528 (discussing specific factors that might raise costs *ex post* including asymmetry of information and idiosyncratic transactions).

202 The presence of such on/off determinations may mitigate the concern on one scholar that parties will invest *ex post* "to turn the bargain in their favor." Katz, *supra* note 9, at 530. Katz is worried that substantive interpretation may facilitate parties overspending on litigation to produce a favorable interpretation. *Id.* Where the determination is an easy on/off one in which the term of art governs or it does not apply, then there may be less incentive to invest in resources than if the case turned on complex factual determinations (such as whether there was just cause to terminate a franchisee).

203 These complex determinations may involve determining whether the trade usage should be admitted for interpretive purposes or whether it should be excluded because it conflicts with express language. These are likely to prove nettlesome when the express language says something specific, such as a fixed quantity, and the usage detracts from the settled, specific nature of that quantity by making it flexible. The question arises whether the parties, by adopting a specific quantity, meant through the express language to exclude the usage allowing for flexibility. In the baker's dozen case, the admissibility of the practice is less prob-

(5) Whether a broad interpretation would operate to control discretion that would otherwise remain uncontrolled under a literalistic interpretation. Courts readily opt for a broad interpretation admitting extrinsic evidence or invoking reasonableness when doing so will control discretion by a party. Because uncontrolled discretion is a threat to bargains and control of opportunism will therefore increase joint gains, parties *ex ante* will want to control discretion. If other strategies such as contract clauses are too costly, parties might rely on reputational and other informal sanctioning mechanisms. However, where the conditions for self-enforcement are not robust (because of poor informational networks) or where the rewards from opportunism are particularly great in relation to the reputational cost,²⁰⁴ the court may play a constructive role through actively interpreting contracts to preclude opportunism. They may do so almost as a court of equity would without creating a pre-announced default rule to govern all cases.²⁰⁵ This approach can be seen in the airplane maintenance case where the court admitted evidence to control the lessee's discretion in performing contractually mandated maintenance.

(6) Whether literal interpretation would leave one party vulnerable after having invested large sunk costs. Courts are willing to broadly interpret contracts and to add terms when one party has invested sunk costs that would be lost under a narrow interpretation. The *Gord*²⁰⁶ court added a term obligating one party to pay a mold removal fee despite the absence of any contract term obligating the party to pay such a fee. The court's interpretation served to protect a party whose large engineering sunk costs would be unrecoverable unless the court implied a term.²⁰⁷

(7) Whether one party would receive an unbargained-for (unanticipated) windfall that could be avoided by a broad, non-literal interpretation. Of course, the windfall issue is a complex one since not all windfalls should be deterred through the interpretation process. *Ervay, Inc., v. Wood*,²⁰⁸ a

lematic because the baker's dozen would simply apply in every case where the word dozen was mentioned. One would not have to figure out whether, by using the word dozen, they meant to exclude the trade usage of a baker's dozen or not. In every case where one dozen is mentioned, the baker's dozen would automatically be substituted.

204 See *supra* note 126.

205 Email from Robert E. Scott, Professor of Law, Columbia University, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University Law School (February 11, 2004) (on file with author).

206 See *supra* note 142.

207 See also *U.S. Naval Inst. v. Charter Commc'ns Inc.*, 875 F.2d 1044 (2d Cir. 1989) (interpreting the word "publish" to permit early publication of the paperback edition but not early sales; otherwise large sunk costs in the hardcover edition would be lost and courts will avoid an interpretation that allows such a loss).

208 *Ervay, Inc. v. Wood*, 373 S.W.2d 380 (Tex. Civ. App. 1963).

case not discussed in this article, illustrates when a court will intervene to police windfalls and opportunism through interpretation. In *Erway* the court had to construe the waiver of a lessee to a condemnation award to be received by the lessor for property owned by the lessor and condemned. *Ex ante* the parties had contemplated the condemnation of Tract A but it turned out that the government condemned other tracts of the leased land. The waiver by the lessee seemed general in nature but if the waiver were broadly construed to include all leased tracts, the lessee would lose the value of all improvements on the other tracts and lessor would gain an unexpected windfall. The court admitted extrinsic evidence to conclude that the waiver should be narrowly construed to apply only to Tract A. That interpretation avoided the lessor opportunistically appropriating the value of the lessee's sunk costs when the lessee and the lessor had apparently shared an understanding that the lessee would only stand to lose investments on Tract A which both parties assumed was the only land that would possibly be condemned.

(8) Whether a secret code exists that is at odds with plain meaning and the code can be translated at low cost. If there is an idiosyncratic meaning but clear evidence of the meaning that can be ascertained at low cost, the court will admit the evidence and broadly interpret the contract. By doing so, they give effect to the mutually intended meaning. To do otherwise would give one party an opportunistic windfall by giving it the benefit of a plain meaning that the parties did not contemplate *ex ante*. Interpreting against such a result curbs a form of opportunism—giving the party a better bargain than that which the contract provided.

(9) Is the admissibility of the evidence likely to embroil the court in difficult to decide complex issues of whether the evidence shows the practice is one of legal right or of one of grace and intended to remain legally unenforceable? Because these matters are likely to depend on information that will arise *ex post* and parties rather than judges are best equipped to judge, courts should be wary about broadly interpreting contracts to include such practices. The *Columbia Nitrogen* case is illustrative of this situation and it is one in which the heuristic suggests that parties should be wary of such interpretation since if proved, it would afford unlimited discretion to one party. Without limits on the discretion, it would seem unlikely that the court's interpretation would be value maximizing.

(10) The robustness of non-legal sanctions. The court should be more willing to actively interpret contracts if the other means of policing against opportunism appear more costly either because the express contract solution would be expensive or there is no active trade association that is engaged in policing and information supply.

CONCLUSION

This article has suggested that theories about judicial interpretation cannot be artificially separated from the question of what courts should do when a contract is incomplete. The new formalists separate those issues by assuming that interpretation issues necessarily involve complete contracts "for the subjects at issue" in which "[c]ourts can only interpret what is said."²⁰⁹ Because all contracts are incomplete, whether the court is interpreting a contract or supplying a default rule for a true gap, the grounds on which the state is intervening is the key methodological issue. Both interpretation and gap filling depend on an assessment of "how the parties would have resolved the issue . . . had they foreseen it when they negotiated their contract."²¹⁰ That assessment must depend on the costs of judicial intervention, including error costs, as well as the benefits of such intervention, including the control of opportunistic behavior.

When the question of justification for a state supplied default rule is separated from the wide ranging contexts in which a court can "interpret" an incomplete contract²¹¹ and the functional role that broad interpretation can serve in curbing hazards and controlling discretion, the case for judicial intervention in interpretive questions may seem less than compelling. This is especially so when the state-supplied default rules discussed by Schwartz and Scott as the typical judicial responses to the incomplete contract problems are general default standards that many parties contract around.²¹² The proclivity of many parties to contract around some state-sponsored defaults under the *Uniform Commercial Code*, such as the default rules "requiring parties to behave 'reasonably,' 'conscionably,' 'fairly,' and in 'good faith,'"²¹³ however, does not resolve whether broad approaches to interpretation will be value maximizing in settings involving incomplete contracts.

This article suggests that the question for courts is whether, when a contract is incomplete, a court should interpret it using a broad range of evidence or whether parties would be likely to contract out of a default rule of contextualized interpretation. There is no single answer to that question. Optimal interpretation will depend on whether judicial interpretation and use of certain evidence will constrain or increase moral hazard, will effectuate the parties' intentions, will require the court to assess factors that the parties are better able to evaluate and on whether a customary trade practice that can reduce the burden on the court for deciding if opportunism has occurred exists. If there are structural factors that can

209 Schwartz & Scott, *supra* note 21, at 594.

210 Posner, *supra* note 3, at 1586.

211 Schwartz & Scott, *supra* note 21, at 594.

212 *Id.*

213 *Id.* at 601.

help identify opportunistic behavior to a court, such as the expropriation of a sunk cost by the non-investing party, as in the case involving the removal of the cost to engineer plastic molds, and trade usages that serve as objective indicators of opportunism, courts may be good at judging whether opportunism has occurred *ex post*.²¹⁴ If opportunism is presumed to be a widespread phenomenon, this approach of admitting extrinsic evidence if it will curb opportunism will satisfy the Schwartz and Scott criteria for an effective default rule—that it be simple and “efficient for a wide variety of contract parties.”²¹⁵

214 I am grateful to Robert E. Scott for raising this point.

215 Schwartz & Scott, *supra* note 21, at 598.