1999

In Defense of the Incorporation Strategy

Jody S. Kraus
Columbia Law School, jkraus1@law.columbia.edu

Steven D. Walt
SWALT@LAW1.LAW.VIRGINIA.EDU

UNIVERSITY OF VIRGINIA SCHOOL OF LAW
Legal Studies Working Papers Series

In Defense of the Incorporation Strategy

(A revised version of this working paper is forthcoming in Jurisprudential Foundations of Corporate and Commercial Law, Jody S. Kraus and Steven D. Walt (eds.),Cambridge University Press, 1999.

Jody Kraus
and
Steven Walt

Working Paper No. 99-4

June 1999

DRAFT

In Defense of the Incorporation Strategy[*]

Jody S. Kraus and Steven D. Walt

I. Introduction

Contract law must provide rules for interpreting the meaning of express terms and default rules for filling contractual gaps. Article 2 of the Uniform Commercial Code provides the same response to both demands: It incorporates the norms of commercial practice.[1] This "incorporation strategy" has recently

---

[*] Prepared for THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW, Jody S. Kraus & Steven D. Walt (eds.), Cambridge University Press (forthcoming 1999).

[1] The incorporation strategy is also adopted in the sales law of other legal systems and in some treaty law. See, e.g., Belgian Civil Code art. 1134 (1982), United Nations

come under attack. Although the incorporation strategy for gap-filling seems to have survived criticism,[2] the incorporation strategy for interpretation remains heavily criticised. Critics charge that the expected rate of interpretive error under an incorporationist interpretive regime is so excessive that almost any plain meaning regime would be preferable.

The attack on the incorporation strategy for interpretation is fundamentally flawed. The best interpretive regime is one that, all else equal, minimizes the sum of interpretive error costs and the costs of specifying contract terms.[3]

Convention on Contracts for the International Sale of Goods art. 9(2), 19 Int. Legal Mat. 668 (1980), International Institute for the Unification of Private Law, UNIDROIT Principles of International Commercial Contracts art. 1.8(2) (1994).

[2] *See generally* Michael Klausner, *Corporations, Corporate Law, and Network Externalities*, 81 VA. L. REV. 757 (1995); Marcel Kahan and Michael Klausner, *Standardizationand Innovation in Corporate Contracting ("or the Economics of Boilerplate")*, 83 VA L. REV. 713 (1997); Jody S. Kraus, *Legal Design and the Evolution of Commercial Norms*, 26 J. LEG. STUD. 277 (1997).

[3] If an interpretive regime that minimizes the sum of interpretive error and specification costs has higher administration costs than a regime with higher total interpretive error and specification costs, the latter may be the preferable regime. *See* Richard A. Epstein, SIMPLE RULES FOR A COMPLEX WORLD 30-36 (1995). The "all else equal" proviso allows for this possibility.

Our case for incorporation is not based on a complete analysis of all relevant variables. Interpretive regimes affect a number of decisions of actual and potential contracting parties, including whether to contract at all, the type of contract, contract performance and the decision to breach. The decision to contract, for instance, is not an exogenously fixed variable. Where performance deviates from the express terms of a contract, use of commercial practice to interpret terms can increase the cost of performance over the life of the contract. In some circumstances, this prospect can make not contracting the preferred decision. A complete analysis of equilibria under different interpretive regimes must estimate the aggregate effect of an interpretive regime on all variables, not just on specification and interpretive error costs. This Article holds the parties' preferences for contracting and contract terms constant and estimates the effect of choice of regime on two important variables. Its analysis is more managable because the estimation is of the effect of

Critics of the incorporation strategy have focused exclusively on the former and completely ignored the latter. Yet the chief virtue of the incorporation strategy for interpretation is its promise to yield specification costs well below that of plain meaning regimes. Even if plain meaning regimes have lower interpretive error costs, the incorporation strategy is superior if its lower specification costs outweigh its higher interpretive error costs. Moreover, most critics treat their objections to Article 2 as objections to the incorporation strategy generally. But Article 2 is just one possible institutional variant of the incorporation strategy. All of the sources of interpretive error critics identify can be substantially reduced, if not avoided, by making feasible alterations to Article 2 that nonetheless preserve its incorporationist character.

This Article defends the incorporation strategy as a method of contractual interpretation. Part II analyzes the debate between incorporation and plain meaning regimes. After explaining the comparative and empirical nature of this debate, we present the intuitive empirical case for believing that incorporationist interpretive regimes will yield significantly lower specification costs than plain meaning regimes. Part III considers recent objections to the incorporation strategy for interpretation. These objections identify several potential sources of interpretive error and offer both a priori and empirical arguments to suggest these errors are likely to be extensive in any incorporation regime. We argue that these criticisms overstate the probable extent of interpretive error under Article 2, and that all of the kinds of interpretive errors identified can be significantly reduced by feasible changes to Article 2. Part IV describes the salient features in Article 2 that implement the incorporation strategy and presents possible amendments to reduce the extent of the interpretive errors identified in Part III. Given the distinction between the incorporation strategy and its implementation, Article 2 can accommodate these amendments without abandoning the incorporation strategy. Part V concludes by summarizing the argument for favoring the

---

interpretive regimes on the likely costs of making particular decisions. The full case for and against incorporation would estimate the range of decisions affected by such regimes.

incorporation strategy for interpreting contracts among a heterogeneous group of contractors: Compared to a plain meaning regime, the lower contract specification costs of a carefully designed incorporation regime will outweigh its higher interpretive errors costs.

II. The Structure of the Incorporation Debate

The contemporary debate about the role of commercial norms in contract interpretation typically pits the incorporation strategy against a plain meaning regime. Although the notion of plain meaning at work is seldom clarified, for our purposes we need only roughly describe it. We understand "plain meaning" to be rule- or convention-based sentence meaning independent of the particular context of sentence use. Plain meaning is literal sentence meaning.[4] We also count as plain meaning approaches ones that exclude commercial custom, even if they rely on other contextual evidence to determine meaning. This extension of "plain meaning" preserves the contrast between the incorporation strategy and plain meaning regimes. It is of course another matter whether literal sentence meaning exists or is useful in resolving the range of interpretive disputes litigated. Because we defend the incorporation strategy against plain meaning regimes, we need not take a position on either

---

[4]Philosophers standardly assume that literal sentence meaning exists, as do some legal theorists. See, e.g., Donald Davidson, Truth & Interpretation 247 (1984), John R. Searle, Speech Acts 19 (1969), Larry Alexander, *All or Nothing at All? The Intention of Authorities and the Authority of Intentions*, in Law & Interpretation: Essays in Legal Philosophy 356, 363-65 (Andrei Marmor ed. 1995), Frederick Shauer, *Statutory Construction and the Coordinating Function of Plain Meaning*, 1990 Supr. Ct. Rev. 213, 251-53. For scepticism about the existence of plain meaning, see Stanley Fish, Doing What Comes Naturally: Change, Rhetoric, and the Practice of Theory in Literary and Legal Studies 508 (1989), Sanford Levinson, *Law as Literature*, 60 Tex. L. Rev. 373, 378 (1982). Contrary assessments of the trend in recent caselaw appear in Margaret N. Kniffin, *A New Trend in Contract Interpretation: The Search for Reality as Opposed to Virtual Reality*, 74 Or. L. Rev. 643 (1995), Ralph James Mooney, *The New Conceptualism in Contract Law*, 74 Or. L. Rev. 1131, 1159-71 (1995).

matter.

Although the contemporary incorporation debate arises in response to Llewellyn's explicit adoption of the incorporation strategy in Article 2, it has precisely the same structure as the classic and familiar debate between the subjective and objective theories of intent in the common law of contract. The same considerations that easily vindicate the objective theory of intent in contract law structure the debate between plain meaning and incorporation interpretive regimes in both contract and sales law. However, because plain meaning and incorporation regimes are both versions of objective theories of intent, these considerations do not so easily settle this debate.

The first lesson taught in first-year contracts is that contractual intent is objective rather than subjective. Even though one of the parties can prove that he understood the contractual term "dog" to mean cat, courts will interpret the term "dog" to mean dog. The lesson seems counterintuitive. The law of contract is designed to vindicate parties' intent, yet one party's subjective understanding of the meaning of the terms of his contract is, by itself, irrelevant to a court's interpretation of those terms.[5] The counter-intuition rests on the erroneous presumption that subjective intent is static rather than dynamic. The party who assigns an idiosyncratic meaning to a contractual term might be surprised the first time he learns his subjective view is irrelevant to its judicial interpretation. But he will not be surprised again. The next time he enters into an agreement, the party will be careful to use terms according to the interpretation a court is likely to give them. Thus, if courts refuse to interpret terms according to the parties' subjective intent, parties will align their subject intent with the "objective" intent courts enforce. Contractors' choice of terms, and the subjective meaning they assign to them, is therefore a function of the contractors' expectation of how courts will interpret contractual terms. Contractual behavior can be explained and predicted only

[5] Of course, if one party can prove that *both* parties shared his idiosyncratic understanding of a contractual term, courts will enforce the term according to that understanding.

by a dynamic rather than static model.

The purpose of a theory of contractual interpretation, therefore, is not merely to select an interpretive rule that is most likely to reflect the parties' subjective intent. This goal can be secured by any interpretive rule that allows parties to predict the likely interpretation of their contractual terms with reasonably certainty. As between equally predictable interpretive rules, the best rule allows the parties to secure their desired interpretation at least cost. Consider an interpretive regime, for example, that enforced key contractual terms only if they appeared on an extensive menu of judicially constructed terms of art. A court would find that an agreement that did not use these terms to specify its key provisions too indefinite and therefore unenforceable. Such a regime would provide an extremely high degree of predictability of judicial interpretation of contract terms. But this predictability would come at a price. Parties would be forced to choose between creating a legally unenforceable agreement or incurring the costs of learning and using the terms on the judicial menu, which might nonetheless vary from the terms they most prefer in their contract. The price of predictability, therefore, is the inefficiency of the resulting contract: Whenever the terms of a contract are at variance with the parties' most preferred terms, the expected joint value of the contract at the time of formation will be sub-optimal.[6]

Thus, a perfect interpretive rule not only enables parties to predict a court's interpretation of contractual terms with complete certainty, but also allows parties to specify their desired contract at no cost. Real world

[6] This assumes that contractors always prefer to maximize the joint value of their contracts ex ante and that their most preferred terms correspond to the most efficient terms. Of course, the former does not entail the latter. Contractors might mistakenly believe their most preferred terms will maximize the joint value of their contract ex ante. But the economic analysis of contract presumes that the parties' preferences provide the best method of approximating the most efficient terms for contracts. The plausibility of this claim stems from the claim that the market will select against parties who include inefficient terms in their contracts, and will favor the evolution of commercial norms that will guide contracting preference formation.

interpretive regimes, therefore, face an unavoidable trade-off between maximizing the predictability of contractual interpretation and maximizing the ability of the parties to specify the most efficient terms for their contracts. To maximize the ability of the parties to specify their most preferred terms, the parties' costs of specifying their most preferred terms must be minimized. Thus, all else equal, the optimal regime minimizes the sum of interpretive error and specification costs.[7] The costs of interpretive error consist in the losses due to both the prospect and actual incidence of interpretive error. The prospect of interpretive error leads to sub-optimal reliance losses. These losses consist in the foregone benefits of the increased reliance that would be efficient in a regime of interpretive certainty, and the direct and opportunity costs of taking affirmative precautions to hedge against the prospect of interpretive error. The actual, rather than prospective, incidence of interpretive error leads to detrimental reliance losses. Specification costs are the costs parties incur in specifying their most preferred terms, such as learning and selecting from a judicially chosen menu of express terms.[8]

The justification for the objective theory of contractual intent is based not merely on the claim that it yields a high degree of predictability of contractual interpretation and thus a low prospect of interpretive error. It also turns on the low specification costs produced by the objective theory. The proposition that

---

[7] Again, the "all else equal" proviso holds the costs of administering an interpretive regime constant across all regimes. See note 2 *infra*.

[8] Specification costs provide the upper bound of the aggregate costs attributable to inefficient contractual terms: The loss in the expected joint value of a contract due to a failure to specify the most efficient terms cannot exceed the costs of specifying the most efficient terms. Otherwise, rational parties would incur the costs of specifying the most efficient terms rather than incur the larger loss in the expected joint value of their contract. Note that under the hypothetical interpretive regime in the text, the costs of securing the most desired terms will be infinite when the parties desire a term not contained in the judicially specified menu. In that case, the upper bound of the aggregate costs attributable to inefficient contractual terms is the entire expected joint value of the contract: Some contracts will have a positive expected joint value only if they contain a term not contained in the judicial menu.

the objective theory will yield a high degree of interpretive predictability is based on two claims. The first is that most terms have a relatively clear, objective "plain" meaning, which consists in their most common interpretation. Because most people know the common interpretation of most terms, both contractors and judges ordinarily will be able accurately to determine objective meaning, and contractors will be able accurately to predict the likely interpretation of their contractual terms. The second is that the costs of learning a term's plain meaning will be lower on average than the costs of learning any alternative meaning these terms might be given. This second claim also supports the proposition that the objective theory of intent will yield low specification costs. The lower the costs of learning the judicially recognized meaning of terms, the lower contractors' specification costs. Further, under the objective theory, parties in principle will always be able to include any term they prefer in their contract. Unlike the hypothetical interpretive regime that limits parties to a finite list of judicially recognized key contractual terms, the objective theory offers contractors all of the English language, which presumably provides an array of terms, each with plain meanings, sufficient to specify virtually any term parties might prefer.

At bottom, the case for the objective theory of intent is comparative. The objective theory of intent will yield an equilibrium producing a sum of interpretive error and specification costs. The choice between the objective theory and any competing theory is decided by determining which theory is expected to yield the equilibrium producing the lower sum of interpretive error and specification costs. If most English language terms have a clear, common, "plain" meaning known to most contractors and judges, or learned at low cost, these costs will not be great. Whether an alternative regime can produce an even lower sum of these costs remains an open empirical question.

The case for the objective theory of intent is traditionally made by comparing it to a purely subjective theory of intent. The objective theory of intent is defended on the ground that it yields an equilibrium with lower total interpretive error and specification costs than a purely subjective theory of intent. The case is easily convincing. Contractors and courts cannot

determine or verify purely subjective intent. Because the interpretive error rate by courts and contractors under a subjective intent regime would be high, the total interpretive error costs would be high. Contract specification costs would also be high because parties would have great difficulty specifying terms with meanings courts would reliably enforce. In contrast, if terms have an objective and verifiable plain meaning, the objective intent regime will clearly lead to an equilibrium with much lower aggregate interpretive error and specification costs. The move from subjective to objective intent in first-year contracts takes a class or two at most.

But the choice between objective and purely subjective theories of intent presents a false dichotomy. Most terms have multiple meanings that can be described along continua of objectivity and verifiability. If many terms have multiple objective meanings, the issue is not whether objective theories of interpretation should be preferred over subjective theories. Rather, it is how we should choose among various possible objective theories. The main objective competitor to plain meaning regimes are incorporation regimes. Incorporation regimes, like plain meaning regimes, are objective because they interpret contractual terms in light of objective and verifiable commercial practices. Thus, unlike the debate between objective and purely subjective theories of intent, the intramural debate between plain meaning and incorporation regimes is far more difficult to assess. Both regimes constitute objective theories of interpretation and both require trade-offs between reductions in interpretive error costs and reductions in specification costs. The debate is a contest between competing empirical intuitions.

There seems to be a consensus that plain meaning regimes are likely to lead to lower interpretive error costs than the incorporation regimes. Plain meaning regimes posit a fairly clear set of nondomain-specific, common meanings associated with most terms, whereas incorporation regimes posit a set of fairly clear but domain-specific meanings. Even assuming both the generic "plain" meaning, and the more specialized domain-specific meanings are equally clear, we would expect a higher rate of interpretive error under incorporation regimes because they require judges (and contractors) to choose

among the various possible meanings of terms. Under a plain meaning regime, the judicially recognized meaning of every term is unique. The only possible source of interpretive error is a misinterpretation of the plain meaning by contractors or judges. Under an incorporation regime, however, contractors and judges can mistakenly identify the domain for which a term's meaning is determined, in addition to misinterpreting the meaning of the term within that domain. Thus, there is only one opportunity for interpretive error under plain meaning regimes. Incorporation regimes, however, present a second opportunity for interpretive error in addition to same opportunity presented under plain meaning regimes. Because the two types of mistakes are not correlated, incorporation regimes would be expected to have a higher rate of interpretive error than plain meaning regimes, all else being equal.

But the comparative strength of the incorporation strategy is its potential for producing lower specification costs than the plain meaning rule. The key insight of the incorporation strategy is that contractors naturally and costlessly use terms that have domain-specific meanings. These terms presumably have evolved to address the particularized needs and expectations of contractors within a given domain. Their efficiency is analogous to the efficiency of terms of art within academic and technical disciplines. Terms of art allow participants familiar with a particular discipline effectively to communicate a complex thought with the ease of one specially defined word or phrase that is widely understood within the discipline.[9] Similarly, it would sometimes be cost-ineffective for some contractors to restate their understanding of all the dimensions of their contractual agreement using the plain meaning of terms. Indeed, some specialized or context-specific terms carry with them an array of implications that might be difficult even to bring to mind, let alone commit to paper. Nonetheless, just as the full connotations of even the plain meaning of terms can be specified by English speakers only when presented with a particular contextualized application, the implications of specialized contractual terms will be clear to the contractors, and every other participant

[9] *See* Richard A. Epstein, *The Path to* The T.J. Hooper*: The Theory and History of Custom in the Law of Tort*, 21 J. LEGAL. STUD. 1, 9-11 (1992)

in their trade or industry, only when particular contingencies arise in their relationship. They will nonetheless "know it when they see it."

If courts interpret contractual terms by attempting to determine whether the parties intended to invoke their plain or domain-specific meaning, the specification costs for parties might be lower than under a plain meaning regime. Under an incorporation regime, contractors can use the terms that express their intent most effectively at least cost. Contractors will choose a less efficient term over a more efficient term whenever the additional cost of specifying the most efficient term exceeds the gains from using the more efficient term instead of the less efficient term. The incorporation strategy can save contractors specification costs by allowing them to use domain-specific meanings customized to suit the needs and expectations of their contracting context. A plain meaning regime imposes on parties the additional costs of either translating the understandings already carried by the domain-specific meanings of available specialized terms into an equivalent statement using the plain meaning of terms, or settling on a less efficient contractual term that can be specified at a lower cost.

Moreover, the plain meaning rule requires contractors to make sure they are not mistakenly relying on a domain-specific meaning rather than a plain meaning. In a complex contractual setting, it may prove extremely costly, and perhaps impossible, to identify all the unwritten interpretations of contractual terms that the contractors naturally and unconsciously presume to be mutually understood. Even when contractors knowingly operate under a plain meaning regime, they will sometimes fail to realize that their understanding of the meaning of a term, particularly commonly used industry terms, will nonetheless not be judicially recognized. To be sure, such mistakes might be less frequent over time. But as long as domain-specific meanings exist, such mistakes are unlikely to disappear entirely.

Thus, the contest between plain meaning and incorporation regimes turns on competing empirical hunches. Which is larger, the interpretive error costs saved under a plain meaning regime, or the specification costs saved under an

incorporation regime? Any comparative analysis of plain meaning and incorporation regimes that focuses exclusively on relative interpretive error costs is seriously incomplete. It must also take into account relative specification costs. The case for the incorporation strategy rests on its claim to significantly lower specification costs than plain meaning regimes.

In Part III, however, we set aside this comparative question to consider the likelihood of interpretive error under incorporation regimes. The criticisms that allege extensive interpretive error under the incorporation strategy, we argue, are overdrawn and one-sided. They either exaggerate the likely extent of interpretive error under incorporation regimes or fail to acknowledge that the sources of interpretive error they identify apply equally to plain meaning regimes.

III. The Critique of the Incorporation Strategy

Three different sorts of charges have been made against the incorporation interpretive strategy and in favor of a plain meaning regime. Although often not distinguished from each other, each charge asserts the likelihood of a particular form of interpretive error. For ease of references, we refer to the charges respectively as "the encrustation critique," "the existence critique," and "the informal norms critique." The existence and informal norms critiques are supported by both a priori reasoning and empirical studies. For each critique, we describe the kind of interpretive error it identifies. Our objective is to isolate the sources of these errors in order to clarify how they might be reduced by the amendments to Article 2 that we suggest in Part IV or by an alternative incorporation regime. Where appropriate, we also argue that these critiques either exaggerate the likely extent of interpretive error under an incorporation regime, or fail to acknowledge that similar errors are likely to be equally extensive under a plain meaning regime.

A. The Encrustation Critique

The first critique of the incorporation strategy focuses on the mechanics of the incorporation process of Article 2. Article 2 requires judges to interpret contractual terms in light of commercial practice. But once courts have made an initial determination of the meaning of a term, based at least in theory on an inquiry into relevant commercial practices, they appear reluctant to engage in that inquiry again. Instead, they appear to treat such determinations as canonical. Thus, although courts might initially employ the incorporation strategy, their initial interpretations become "encrusted" as virtual precedents. Courts subsequently disfavor any interpretations inconsistent with these encrusted interpretations.[10] One suggestion is that courts are predisposed to treat statutory interpretation in a static, precedent-bound, fashion, rather than the dynamic fashion contemplated by the incorporation strategy. Thus, incorporation implemented by Article 2, rather than through a common law system, might account for this judicial interpretive intransigence.

The judicial practice of one-time incorporation is inconsistent with the goal of interpreting contractual terms in light of their evolving meanings. If parties understand their contractual terms in light of evolving commercial practices, encrustation will lead to interpretive error. If parties recognize and

---

[10] The classic encrustation critique is presented in Charles 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 (1985). Encrustation describes two phenomena. The first is a status quo bias in favor of default terms. The status quo bias weights default terms by resolving ambiguities in the meaning of express terms to preserve the continued application of default terms to the contract. See Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 Cornell L. Rev. 608 (1998), Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Bias*, 74 WASH. U. L. Q. 347, 359-62 (1996). The second is the reliance on precedent to determine the customary meaning of contract terms. This interpretive practice results in a failure to recognize changes in customary meaning. Because a decisionmaker can interpret express terms without consulting default rules while also not recognizing changes in commercial practice, this second kind of encrustation can occur without the first. Both kinds of encrustration lead to a failure to acknowledge clear efforts by contractors to opt out of default rules or (stale) custom.

respond rationally to the judicial practice of one-time incorporation, their costs of specifying their most preferred terms will increase. If courts will not interpret contractual terms in light of current commercial practices, parties will have to incur the costs of making explicit any of their understandings at variance with outdated practice, or settle for the sub-optimal interpretation of their contractual terms according to the outdated practice. The costs of "opting out" of the encrusted interpretations of their terms are exacerbated by the tendency of courts to disfavor such opt-outs. If courts refuse to interpret terms in light of evolving commercial practice, the value of attempting to "opt out" of encrusted interpretations is reduced. Even if parties incur the costs to provide an otherwise clear opt out, courts might nonetheless refuse to enforce the parties' interpretation. This practice thus reduces the expected joint value of all contracts by depriving parties of the ability to specify their most preferred terms.

Encrustation is a potentially serous problem for incorporationists. The tendency of courts to make one-time interpretations of terms instead of continually updating their interpretations in light of evolving practice is inconsistent with the implementation of the dynamic incorporation process contemplated by the incorporation strategy. The tendency to disfavor even clear efforts to opt out of encrusted interpretations constitutes simple interpretive error. How serious a problem encrustation presents depends on the relative frequency of interpretive error resulting from a failure to recognize changes in commercial practice or a bias against clear opt-outs. These in turn depend on how the incorporation strategy is implemented.

But plain meaning regimes are likely to suffer from shortcomings similar to those caused by encrustation. First, encrustation undermines the incorporation strategy because it prevents parties from easily invoking the current customary meanings attached to their contract terms. It thus raises the parties' specification costs. But plain meaning regimes do not even attempt to enable parties to invoke customary meanings a minimal cost. They instead require parties to communicate their customary understandings according to the plain meaning of the terms they use. Thus, although encrustation erodes

some of the expected savings in specification costs under the incorporation strategy, the expected specification costs under plain meaning regimes will be even higher. Second, encrustation undermines the incorporation strategy because judges refuse to honor parties' attempts to opt out of the customary meanings assigned to their contract terms. Again, this judicial practice raises expected specification costs under the incorporation strategy. But if judges favor the customary meaning of contract terms when they interpret under an incorporation regime, we would expect them to favor the plain meaning of terms a plain meaning regime. For example, if contractors state that their quantity terms are estimates, judges might nonetheless hold the parties to the plain meaning of their quantity term. It is difficult to understand why judges would be biased in favor of the customary meaning of terms under an interpretive regime that accords primacy to customary meaning, while not exhibiting a similar bias in favor of the plain meaning of terms under a regime that accords primacy to plain meaning.

B. The Existence Critique

The existence critique argues, on both an empirical and a priori basis, that commercial practices might be less extensive and less clear than proponents of the incorporation strategy have supposed.[11] The extreme form of this critique suggests that commercial practices suitable for incorporation might not even exist. Were this the case, the incorporation strategy at best would be a useless interpretive strategy. Attempts to employ the strategy would end in a vain attempt to identify relevant commercial practices. At worst, fact finders might wrongly believe that a commercial practice exists and thus mistakenly

---

[11] The empirical claim is illustrated by Lisa Bernstein's empirical study of the codification efforts by merchant associations around the turn of the century and merchant responses to proposed Article 2. *See* Lisa Bernstein, *The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study* (unpublished manuscript) [hereinafter Questionable Empirical Basis]. The a priori claim is illustrated by Richard Craswell's argument that trade practices might not exist because of their ineliminably contextual nature. *See* Richard Craswell, *Does Trade Custom Exist*, this Volume.

interpret a contract term in light of the non-existent commercial norm. But the extreme critique must overcome an extremely strong pre-theoretical empirical presumption that wide-spread, identifiable, and effective commercial practices do exist. The near-universal insistence by merchants of all kinds that their conduct is governed, in large measure and important respects, by relatively clear commercial norms justifies a demand that evidence be presented for their non-existence. To date, only one empirical study has been presented in support of the existence critique.

Lisa Bernstein has recently offered a case study to support the claim that "usages of trade and commercial standards, whose geographic reach is coextensive with the reach of the relevant trade, is a legal fiction rather than a merchant reality."[12] Her study examines the debates surrounding merchant industry efforts to codify commercial customs in the hay, grain & feed, textiles, and silk industries near the turn of the century. She argues that these debates, as well as interview evidence and testimony of merchant associations when Article 2 was proposed, reveal wide-spread disagreement among merchants regarding the commercial customs in their trade. Bernstein's study constitutes a worthwhile preliminary effort to uncover the nature and extent of commercial custom. But it does not make a convincing case against the existence of the kind of commercial practice posited by the incorporation strategy.

The most important limitation of Bernstein's study is that, even by its own lights, it demonstrates at most that there were few, if any, uniform, national customs in many commercial industries around the turn of the century. Bernstein concedes that her data supports the claim that local customs existed at the time of these debates.[13] Indeed, the very codification efforts giving rise to the debates she examines indicate that at least industry members themselves

---

[12] Questionable Empirical Basis, p. 7.

[13] In a footnote, she does express some minor scepticism about even this claim, however. See Questionable Empirical Basis, p. 9, n. 26.

believed that an extensive and important set of customs existed. Their objective was not to create trade rules out of whole cloth but to *unify* industry customs and thereby eliminate pre-existing, wide-spread, differences between local customs. Thus, Bernstein's study at most provides some evidence that uniform industry-wide commercial customs may not have been very extensive around the turn of the century. If the incorporation strategy required such customs to exist, Bernstein's study might provide reason to doubt its viability at least at the time Article 2 was created.

But neither the incorporation strategy in general nor Article 2 in particular requires that uniform industry-wide commercial practices exist. Indeed, the commentary to Article 2 itself states that usage of trade should be used to interpret the language in contracts so that it means "what it may fairly be expected to mean to parties involved in the particular commercial transaction *in a given locality* or in a given vocation or trade."[14] If Bernstein's study is correct, the incorporation strategy at the turn of the century would have been useless in interpreting contracts between merchants in localities with different customs. But within localities, Bernstein's study strongly supports rather than undermines the existence of precisely the extensive and robust customs the incorporation strategy anticipates.[15]

---

[14] U.C.C. § 1-205, com. 4 (emphasis added). *See* Joseph H. Levie, *Trade Usage and Custom Under the Common Law and the Uniform Commercial Code*, N. Y. U. LAW REV. 1101, 1107 (1965)

[15] In fact, the very evidence on which Bernstein's principally relies for the claim that no uniform, industry-wide practices existed often provide strong and direct evidence of the existence of relatively clear local customs. Consider the National Hay Association debates Bernstein quotes as support for the claim that there was no uniform customary understanding of what constituted a "bale of No. 1 hay." The passage she includes in the text of her article quotes a member as stating if one were to "[p]ut twenty bales of different grade hay along that room, . . . there will not be five men among you who will agree" on whether each bale contains no. 1 hay. Questionable Empirical Basis, p. 10. But in a footnote, Bernstein quotes members at subsequent conventions as stating that "Grades cannot be expected to suit the South, North, East and West with the same degree of satisfaction" and that "What is considered as No. 1 Timothy, for example, in one producing

As a critique of the incorporation strategy, Bernstein's study has at least two other weaknesses. First, the dearth of uniform, trade-wide customs in the early part of the century provides slight evidence that such customs do not exist now.[16] As Bernstein repeatedly acknowledges, the express purpose of the codification efforts she studied was to unify industry customs.[17] At the turn of the century, trade economies were just beginning their transformation from a local to a national and international market. The codification efforts likely coincided with the rising nationalization of the American economy. Far from evidencing a lack of commercial custom, these efforts demonstrate the centrality of custom to industries. As the need to compete in the national marketplace became immediate, merchants likely felt they could not wait for a nationally uniform customary practice to evolve as local customs had evolved. The codification efforts suggest that the American economy had grown faster than the rate of customary evolution. Significant secular changes in domestic markets over at least the last half century make earlier trade practices poor evidence of contemporary practices.

Second, although Bernstein claims the evidence she considers

---

section may be considered as No. 2 Timothy in another producing section, and still of another grade in the consuming section to which it may be shipped." Questionable Empirical Basis, p. 10, n. 34. Bernstein's basis for concluding that no uniform, industry-wide customary understanding of the meaning of "no. 1 hay" existed is that the evidence suggests instead that there existed many relatively clear but conflicting local customary understandings of the meaning of the term, "No. 1 hay." Thus, the same evidence that supports Bernstein's conclusion that no uniform, industry-wide standard for grades of hay existed is itself equally strong evidence of the existence of relatively clear local customary understandings (of the meaning of "No.1 grade hay" in the present example.)

[16] *See* Clayton P. Gillette, *Harmony and Stasis in Trade Usages for International Sales*, VA. J. INT. LAW (forthcoming).

[17] Bernstein correctly notes that the codification efforts themselves do not demonstrate the paucity of national, uniform customs. There are a variety of important reasons for codifying even relatively clear and uniform customs. See Bernstein, Questionable Empirical Basis, p.29, n.132.

demonstrates that industry-wide customs did not exist, much of the evidence at most establishes that some customs were not ideally precise. For example, Bernstein reports that members of the National Hay Association disagreed over whether the term "carload" meant ten tons or twelve tons.[18] Such evidence at most establishes that customary understanding was not always sufficiently precise to resolve any possible interpretive dispute. Assuming the debates accurately reflect the lack of consensus in the industry over the definition of a "carload," custom could not be invoked to adjudicate a dispute between merchants over whether a contract calling for a carload of hay to be delivered would be satisfied by a 10 ton rather than 12 ton shipment of hay. But on this evidence, it is plausible to suppose that custom does establish that an 8 ton shipment would not constitute a "carload" and that a 12 ton shipment would constitute a "carload." Thus, evidence of imprecise customs is not evidence of no custom at all. The incorporation strategy is useful even if it incorporates imprecise customs, so long as those custom serve at least to define a range of reasonable and unreasonable disagreement over the meaning of contract terms.

The empirical case against the existence of commercial practice is unconvincing. However, the existence critique, in either its empirical or a priori form, can be cast more modestly. The modest existence critique concedes that fairly extensive and robust commercial practices are likely to exist but maintains that by their nature they will be difficult for judges to verify and so incorporate. This critique properly identifies and undermines the naive view of commercial practices that conceives of them as bright-line rules easily identifiable from within or without the profession they govern. It rightly reveals commercial practices to be subject to precisely the same kind of interpretive difficulties presented by ordinary terms in any language. In both cases, their meaning is seldom reducible to a simple, easily stateable finite set of propositions, but rather is largely contextual. Although one might be able to state some relatively clear "core" instances of the application of any given

---

[18] Questionable Empirical Basis, p. 12, n. 48.

term, the application of most terms must await a particular context for its resolution. Even then, reasonable people might disagree about its proper application. Meaning is both contextual and fluid, and therefore characterized by a constant evolution in which one ambiguity is clarified only by raising another.

Clearly, the incorporation strategy for contractual interpretation would be almost useless if it required commercial practices to take the form of bright-line rules. Few such practices are likely to exist. Determining the content of commercial practices engages the same interpretive enterprise required to understand the meaning of ordinary language. This hardly presents an insuperable obstacle to the incorporation strategy. The difficulties of interpreting the content of commercial practice make it almost inevitable that judges will make mistakes in identifying and incorporating commercial practices. In some cases, judges might believe they have identified a commercial practice when in fact there is no such practice.[19] In other cases, they might correctly believe there to be a commercial practice bearing on the correct interpretation of a term but mistakenly interpret the content of that practice. Incorporation strategies can reduce the incidence of these errors. They can provide specifically designed provisions to alert the trier of fact to the possibility that commercial practice sometimes will not exist, and to insure against a finding that commercial practice exists when it does not. The modest version of the existence critique supports only the conclusion that the incorporation strategy be carefully implemented, not that it is bankrupt.

---

[19] Interestingly, Bernstein points out a case in which the court concludes "that no usage existed because the plaintiff contends [the word 'prompt'] meant 'by first available ship' and defendant that it meant thirty days. Bernstein, Questionable Empirical Basis, p. 11, n. 42. On the one hand, this case illustrates that courts are capable of doing precisely what Bernstein fears they will not do: Determine that no usage of trade exists when in fact no usage of trade exists. On the other hand, the case provides a particular poor example of how a court should make such a determination. The mere fact that the parties disagree ex post about the interpretation of a term should be irrelevant to a determination of whether that term has a customary meaning.

C. The Informal Norms Critique

The informal norms critique points out that not all commercial practices provide good evidence of the intended meaning of contractual terms. Some commercial practices are indicative of "formal" norms, which parties intend to be given legal effect, while others indicate "informal" norms, which parties intend not to be given legal effect. The paradigm evidence of a formal norm is provided by trade-wide contractual practices. For example, suppose that 90% of a representative sample of contracts for the sale of horses disclaimed the warranties of merchantability and fitness for a particular purpose. There is little question that this evidence establishes the existence of a commercial norm of warranty disclaimer in sales of horses and that this norm is intended by contractors to be given legal effect.

In contrast, informal norms are common commercial practices that are intended by their practitioners not to be given legal effect. The paradigm evidence of an informal norm is provided by trade-wide testimony that a practice is not intended to be given legal effect. For example, suppose that horse sellers routinely exchange or return the price for lame horses that were accepted by their buyers. But every horse seller will testify that this practice constitutes a legally optional accommodation, rather than a legally binding obligation. In fact, they might well claim that the desirability of the accommodation practice turns crucially on the availability of the legally enforceable right to enforce the original trade. Such an informal practice might arise in order to preserve an on-going relationship with a set of repeat buyers.[20] But the same transactors who follow these norms might do so only because they take themselves to have preserved the option of enforcing their

---

[20] Bernstein calls these "relationship-preserving norms." *See* Lisa Bernstein, *Merchant Law In a Merchant Court: Rethinking the code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1796 (1996) [hereinafter Merchant Law]; *See also* Edward B. Rock & Michael L. Wachter, *The Enforceability of Norms and the Employment Relationship*, 144 U. PA. L. REV. 1913 (1996).

more stringent contractual rights-- in this case, refusing to exchange or refund the price of the horse. Contractors might invoke their stricter, contractual rights whenever they consider their contracting partner to be behaving opportunistically. Such behavior is more likely at the end of a contractual relationship, when further contractual interaction between the parties is unlikely, rather than in the middle of an on-going relationship.[21] In specifying the terms of their contract, parties attempt to create an optimal mix of formal and informal norms to mediate their relationship. The informal norms critique argues that the incorporation strategy, as implemented in Article 2, undermines this optimal mix by formalizing informal norms.

Thus, the informal norms critique presupposes that contractors intentionally select from a rich set of formal and informal norms an optimal combination of norms to regulate their conduct. If the premise of the critique is that incorporation of informal norms undermines this optimal mix, there must be many formal and informal norms for courts to confuse with one another. After all, if there are few commercial norms of any sort, as the existence critique maintains, the problem of incorporating informal norms would hardly present a serious problem.

Like the existence critique, the informal norms critique has both an a priori and an empirical form. The a priori informal norms critique simply relies on the fact there are some informal norms to conclude that an incorporation regime such as Article 2 might incorporate an informal rather than a formal norm. Clearly, the possibility exists that informal norms sometimes will be incorporated under an incorporation regime, and clearly such incorporation is undesirable in any interpretive regime. But in order to constitute a critique of the incorporation strategy, much more is required than establishing the mere possibility that an incorporation regime might incorporate some informal norms. The informal norm critique must instead show that even well-designed incorporation regimes inevitably would so frequently incorporate informal

---

[21] Bernstein calls these "end-game norms." *See* Merchant Law, at 1796-97.

norms that they would be inferior to most plain meaning regimes on that account alone. There is, however, no reason to believe that all incorporation regimes would incorporate informal norms frequently, let alone so frequently that the entire incorporation approach must be rejected. In fact, there is no reason to believe that Article 2 itself frequently incorporates informal norms, or that feasible revisions to Article 2 could not insure that such instances would be rare.

Article 2 does not explicitly direct courts to distinguish between formal and informal norms. However, Article 2 clearly does not contemplate or condone the incorporation of informal norms. No court applying Article 2 would intentionally incorporate informal norms. This is because an informal norm cannot be evidence that the term is intended to be enforced. In other words, the evidence goes to something that is not a term of the contract. Indeed, the informality of a norm entails that no term in the contract at issue can be interpreted as having a meaning governed by the norm. It is simply no part of the parties enforceable set of obligations. Thus, any court that identified a norm as informal must already have concluded that the norm cannot be used as a basis for interpreting the meaning of the contract. The court's prior determination of the norm's informality would *constitute* its finding that the norm does not inform the meaning of any of the contract's terms.

Accordingly, the incorporation strategy is not embarrassed by commercial practices reflecting both formal and informal norms. Instead, these practices simply raise another potential source of interpretive error. Under Article 2, for example, judges might mistakenly incorporate an informal norm in the process of interpretation. The possibility is unexceptional. Judges can make mistakes in passing on any aspect of the sales contract, from formation questions to remedies. So the question is whether this kind of interpretive error will be so extensive and costly that Article 2 and other incorporation regimes will be less efficient than available non-incorporation interpretive regimes. The answer depends on the precise design of the incorporation process and on the base rate of observable contractual activity that is inconsistent with the legal duties

contractors intentionally undertake in their contracts. When both variables are taken into account, the probability of erroneous incorporation of informal norms is unlikely to be as extensive as the current literature suggests.

Consider how Article 2 directs courts to determine the existence of a commercial norm in the process of interpreting contractual terms. The predicate for a finding that a usage of trade exists is an empirically observable regularity in the conduct of a majority of contractors in the relevant trade.[22] The predicate for a finding that a course of dealing or course of performance exists is a pattern of observable behavior by the parties.[23] Before the finder of fact can incorporate a norm under Article 2, it must first have evidence of observable regularities in the conduct of merchants or the parties to the contract in dispute. Unless the finder of fact ignores this requirement, no norm, whether informal or formal, can be incorporated into an agreement in the absence of a prior finding of the existence of a pattern of observable conduct that serves as evidence of the norm. Therefore, in order for an informal norm to be incorporated under Article 2, there must be some pattern of behavior by merchants in the relevant trade or the parties to the contract in

---

[22] A usage of trade is "any practice or method of dealing having such regularity of observance . . . as to justify an expectation that it will be observed with respect to the transaction in question." U.C.C. § 1-205(2). Section 1-205(2) requires that "[t]he existence and scope of such a usage are to be proved as facts." The Code commentary emphasizes that "[a] usage of trade . . . must have the 'regularity of observance" specified," and provides that "full recognition is thus available for new usages and for usages currently observed by the great majority of decent dealers." U.C.C. § 1-205, com. 5.

[23] "A course of dealing is a *sequence* of previous conduct between the parties to a particular transaction . . . ." U.C.C. § 1-205(1) (emphasis added). "Course of dealing under subsection (1) is restricted, literally, to a *sequence* of conduct between the parties previous to the agreement." U.C.C. § 1-205, com. 2 (emphasis added). "Where the contract for sale involves *repeated* occasions for performance by either party . . . any course of performance accepted or acquiesced in without objection shall be relevant to determine the meaning of the agreement." U.C.C. § 2-208(1) (emphasis added). "A single occasion of conduct does not fall within the language of [the section defining course of performance]." U.C.C. § 2-208, com. 4.

dispute that provides observable evidence of the norm.

Erroneous incorporation of informal norms is possible, therefore, only to the extent that such norms are evidenced by observable patterns of behavior. The principal empirical premise of the incorporation strategy is that *most* such observable patterns of behavior consist in conduct to which contractors take themselves to be entitled under their contract. Correspondingly, relatively few patterns of behavior are understood by contractors as exceeding their contract entitlements and therefore requiring permissions or waivers of rights. The existence of informal norms establishes that some observable patterns of behavior fall into the latter category. But not all informal norms are evidenced by observable patterns of behavior. And those that are might correspond to a relatively small proportion of observable regularities in commercial behavior.

Our supposition is that the Code's empirical premise is correct. The literature suggests that informal norms most commonly will develop in the context of relational, rather than discrete, contracts. Many, perhaps a majority, of the transactions governed by Article 2 are discrete.[24] Because informal norms are unlikely to play a significant role in discrete contracting, the risk of erroneous incorporation of informal norms in this context is relatively low. But even in relational contracts, which might describe a large number of Code-governed transactions, most behavioral regularities evidence norms that are likely to be formal.[25] Therefore, most behavioral regularities are good

---

[24] *See* Larry E. Ribstein and Bruce H. Kobayashi, *An Economic Analysis of Uniform State Laws*, 25 J. LEG. STUD. 131, 150 (1998)

[25] The mere existence of a regularity of commercial behavior at odds with the plain meaning of a contractual term alone is no evidence of the existence of an informal norm. The behavior is equally consistent with the parties intending that the contract term be interpreted by their behavior under the contract, not plain meaning. For instance, suppose the sales contract calls for delivery of "10 bushels of No. 1 wheat per month." Seller, having difficulty fulfilling all its orders, delivers 8 bushels every previous month. Buyer does not complain. The question is whether the contract calls for delivery of 10 bushels in a subsequent month. Delivery of 8 bushels previously is equally consistent with the following

evidence of formal norms. Informal norms counseling flexibility are surely important in their domain, but their domain is quite limited, even within the relational setting.

Thus, even if the Code indiscriminately incorporated all norms evidenced by observable regularities of conduct, most of the norms incorporated would be formal. Even if fact finders inferred formal norms from behavioral regularities in all instances, they would be right more often than wrong. But of course, the fact finder under the Code does not indiscriminately apply norms to the contract. Evidence of a norm's informality is relevant to persuading the fact finder not to incorporate it. Under Article 2, there are two principal methods of demonstrating the existence of an observable regularity of conduct: expert testimony and evidence about statistical regularities. Expert testimony sometimes can straightforwardly ascertain whether most transactors regard the norm as legally binding. The experts will presumably speak directly to that question. Disagreement among experts is no more of a problem here than elsewhere. But much of the evidence of commercial norms might consist simply in the presentation of evidence of statistical norms--mere frequencies of a given behavior in the trade, in past dealings between the parties, or in the course of performance under the contract in question. This evidence will not settle whether there is an informal or formal norm. The rate of erroneous incorporation of informal norms will be directly affected by the manner in which the trier of fact seeks to determine whether such statistical norms are informal or formal. Our observations suggest that as a statistical matter, there is a high probability that the regularity indicates the existence of a formal, rather than informal norm. But when the reverse is true, the only method for reducing the probability of erroneous incorporation is either to seek expert testimony or require that the trier of fact have some level of relevant expertise itself.

---

two interpretations of the contract's quantity term: (1) "10 bushels" (which Buyer can insist on but has not to date); or (2) "10 bushels or 8 bushels when Seller has difficulty fulfilling its orders." Behavior inconsistent with the plain meaning of the quantity term does not show that an informal norm is operating.

Empirical studies could demonstrate the prevalence of interpretive error in Article 2 resulting from the incorporation of informal norms. They could therefore provide either direct or indirect evidence of the efficiency of one kind of regime over the other. Direct evidence of the regimes' comparative efficiency is a basis for inferring either the absolute or relative costs of interpretive error and specification costs under either kind of interpretive approach. Evidence of the absolute costs of interpretive error and specification under only one regime by itself allows no inference about the relative merits of the two approaches. In order to determine which regime is likely to be more efficient, the absolute costs of interpretive error and specification under the alternative approach must be estimated. Only partial and inconclusive evidence of the relative merits of each regime is given by an empirical study presenting data on the relative costs of interpretive error, for example, but not specification under each regime. To determine which regime is likely to be more efficient, data would be needed concerning the relative costs of specification under each regime.

An empirical study, however, might reveal only indirect evidence of the comparative efficiency of these regimes. If both regimes are available to contractors, and the majority of contractors choose one consistently over the other, where the only plausible explanation for the choice is that contractors prefer it, then that regime is likely to be the most efficient. Similarly, if only one regime is made available without cost, and a second regime can be created by contractors willing to incur the costs of its creation, choice of the second regime by the majority of parties is strong indirect evidence of its superior efficiency.[26]

---

[26] Of course, the failure of a majority of contractors to create an alternative interpretive regime would not constitute evidence that such a regime is less efficient than the prevailing regime. Transition costs, network externalities, learning costs, and structural obstacles to collective action could explain why contractors might continue to utilize a less efficient regime even when the aggregate costs of create and utilizing a more efficient regime would be exceeded by the benefits of such a regime. In contrast, overcoming these obstacles to create and utilize an alternative regime is fairly strong evidence that the regime is more

The only empirical evidence offered to refute the incorporation strategy have been Bernstein's data.[27] She presents them as a challenge to "the fundamental premise of the Uniform Commercial Code's adjudicative philosophy, the idea that courts should seek to discover 'immanent business norms' and use them to decide cases."[28] Bernstein studied the arbitration system adopted by the National Grain and Feed Association (NGFA). The NGFA opted out of the Code's interpretive regime and created its own formalistic arbitration system. Its system substitute trade rules and a formalistic interpretive system for the Code's reliance on usage of trade, course of dealing, and course of performance. Indeed, according to Bernstein, arbitrators sometimes even note that they are prohibited from taking into account trade usage inconsistent with the express terms of the contract. Her interviews with grain and feed merchants suggest that members of the NGFA prefer their formalistic system to the Code's regime because it allows them to achieve their most desired mix of informal and formal norms to govern their contractual relationships. There is no question that the likelihood of interpretive error due to incorporation of informal norms is much lower for contracts adjudicated under the NGFA regime than for contracts adjudicated under the Code's regime.

Bernstein's case study might be taken to provide direct or indirect evidence of the relative size of interpretive error costs in incorporation and non-incorporation regimes. The NGFA study gives direct evidence that one kind of interpretive error is less under the NGFA regime than under the Code regime. If the incidence of other kinds of interpretive error is the same in both regimes, the study would provide incomplete but direct evidence bearing on the relative efficiency of both regimes. The study is incomplete because it does not purport to determine the relative specification costs under each regime. But even without an empirical study of relative specification costs, it

---

efficient than the one it replaces.

[27] Lisa Bernstein, Merchant Law, *supra* note ?.

[28] *Id.* at 1766.

seems clear that the specification costs under the NGFA regime will be no greater, and in fact will probably be much less, than the specification costs NGFA members would face if forced to adjudicate their contracts under the Code regime.

Ordinarily, an interpretive regime that excludes extrinsic evidence of the meaning of contract terms increases specification costs relative to a regime that does not. This is because parties under a non-incorporation regime will have to incur the costs of using terms with plain or pre-defined meanings to express ideas more easily expressed using terms with context-specific meaning, or settle for less efficient contractual terms. But the NGFA provides its members with an extensive set of pre-defined terms whose meanings are entirely derived from common commercial practice in the grain and feed industry. By providing such a tailored list of pre-defined express terms, the NGFA eliminates the chief advantage of incorporation regimes over non-incorporation regimes. The specification costs for NGFA contractors under the NGFA regime are certain to be lower than under any incorporation regime. This is because contractors achieve all the benefits of incorporation by incorporating all relevant commercial practice in their pre-defined trade rules and terms rather than in the course of adjudication. The adjudicatory process therefore can be dedicated solely to the task of enforcing pre-defined terms, without thereby imposing on contractors any additional costs of aligning their contractual practices with these pre-defined terms. Because the NGFA intentionally selects the pre-defined terms its members most prefer terms--terms with meanings reflecting the most common commercial practices in the grain and feed industry-- a strict construction rule in favor of the pre-defined meanings for these terms can be adopted without increasing contractors' specification costs. In this way, the NGFA system thereby eliminates the ordinary tension in adjudication between interpretive strategies that minimize interpretive error costs and those that minimize specification costs. The NGFA's strict construction regime, then, appears to have both lower interpretive error costs and lower specification costs than the incorporation strategy. Thus, it might appear that the NGFA study provides good evidence that non-incorporation regimes are likely to be superior to incorporation

regimes.

The NGFA study, however, establishes only that the NGFA provides a superior interpretive regime *for the members of the NGFA*. It says nothing about the majority of contractors whose agreements are governed by Article 2. The NGFA study illustrates the well-known efficiencies of custom-tailoring rules of contractual interpretation to the needs of specific kinds of contractors. If all contractors shared the same commercial understandings, needs, and practices, as do the members of the NGFA, the incorporation strategy would serve no purpose. An NGFA-like regime instead could be employed to govern all sales contracts. There would not be an unavoidable trade-off between customizing contractual terms in the process of adjudication, thereby reducing specification costs, and reducing interpretive error by adhering to the strict construction of pre-defined terms. Instead, the pre-defined terms themselves could be customized to suit all parties' contractual preferences, eliminating the need to attempt such customization during the course of adjudication. Thus, if contractual preferences are homogeneous, customization can be achieved ex ante, at the stage of pre-defining a menu of contractual terms, rather than ex post, during the adjudicative process. If customization is achieved ex ante, there is no need to attempt customization ex post, and therefore no need to introduce the additional risk of interpretive error associated with ex post customization attempts.

More generally, if contracting parties shared a narrow set of commercial understandings, needs, and practices, there would be no need for a generalized sales law such as Article 2. Of course, an NGFA-like regime that combined custom-tailored, pre-defined terms with strict construction adjudication would optimize contractual interpretation for such an homogenous group.[29] But the

[29] As Bernstein acknowledges, the NGFA system is narrowly tailored to the uniform and idiosyncratic needs of its members. For example, it is suitable only for transactions in which most significant contingencies are well-known in advance, most contractual arrangements are simple, the benefits of national uniformity outweigh any advantages of local variance, and mitigation is typically simple and universally available. In

whole point of the incorporation strategy is to accommodate the impossibility of ex ante customization in a sales law designed to govern an extraordinarily heterogenous population of contractors. The incorporation strategy is explicitly designed to tradeoff the risk of increased interpretive error in order to capture some of the efficiencies of custom-tailored interpretive rules. Karl Llewellyn's gambit is that the efficiency gains the incorporation strategy makes possible will outweigh the interpretive error costs it occasions. The NGFA example provides a perfect solution to the Code's interpretive challenge by assuming away the problem.

The NGFA example also might be indirect evidence of the superior efficiency of a non-incorporation regime over an incorporation regime. The willingness of NGFA members to incur the costs of creating the NGFA strict construction regime to opt out of the Code's incorporation regime might be taken to indicate the superiority of strict construction regimes over incorporation regimes. But no such inference is justified. First, opting out by the NGFA members at most is evidence of the NGFA's superior efficiency over Article 2's particular version of the incorporation strategy. It provide no evidence that a strict construction regime other than the NGFA is superior to Article 2's incorporation strategy or even that the NGFA is more efficient than any incorporation regime other than Article 2.

Second, and more important, the NGFA study does not even demonstrate that the NGFA regime is superior to Article 2. As explained above, the superiority of the NGFA for NGFA members has no bearing on the merits of Article 2's incorporation strategy. Indeed, Article 2 explicitly invites contractors to opt out of the Code's regime when doing so would be efficient. The ability of NGFA members to opt out of the Code's regime in part vindicates, rather than refutes, the design of Article 2 by demonstrating the efficacy of its opt-out provisions. This is because the Code anticipates that

---

addition, its trade rules and term definitions are custom-tailored for grain and feed transactions.

groups of homogenous contractors sometimes will be able to secure gains from forming a distinct adjudicative regime, which exploits the advantages of ex ante customization, that exceed the costs they must incur to form and operate such a regime. The Code does not try to provide a more efficient regime for such contractors than they can provide for themselves. Instead, it is designed to be the most efficient regime for governing a set of heterogenous contractors whose contracting preferences cannot, except in very broad terms, be effectively anticipated in advance. The Code's comparative inefficiency would be indirectly shown only if some individuals with largely heterogenous preferences would opt out of the Code for a private interpretive regime. Instead, the NGFA example proves the unsurprising exception but leaves the rule of incorporation completely intact.

E. Summary

Each critique correctly identifies the possibility of one kind of interpretive error but fails to estimate the likely extent of interpretive error. Because every interpretive regime produces some interpretive error costs in order to reduce specification costs, the only relevant question is whether the incorporation strategy has greater aggregate interpretive error and specification costs than alternative interpretive regimes. The question therefore is a comparative one. We have speculated that the kinds of interpretive error identified are unlikely to be so great as to clearly disqualify the incorporation strategy outright. Indeed, if the error rate were so high, most merchants would at least attempt to opt out of most of the Code's provisions. There is no doubt, however, that the chief liability of the incorporation strategy is its vulnerability to interpretive error. Part IV canvasses measures that might be taken to improve the interpretive error rate under Article 2. We argue that such changes are entirely feasible and realistic. Once in place, these changes could dramatically reduce the current interpretive error rate under Article 2.

IV. Implementing a Defensible Incorporation Strategy

The incorporation strategy for interpreting contracts directs courts to interpret the meaning of contract terms in light of relevant extrinsic evidence, such as trade usage, course of dealing, and course of performance. But it does not specify how a court is to take such evidence into account. Interpretive regimes can implement the incorporation strategy in many different ways. They can vary along a number of crucial dimensions of institutional design. First, they might allocate the responsibility for deciding whether a usage of trade, course of dealing, or course of performance exists to different decision-makers. The decision could be allocated to the court, a lay jury, or a merchant jury. Second, they might apply different standards for proving the existence of extrinsic evidence. Although precise formulations of such standards are notoriously difficult, familiar standards range from a "preponderance of evidence" to "clear and convincing evidence." And they might apply different standards for the kind of proof that can be offered to prove the existence of extrinsic evidence. For example, one regime might require evidence of statistical regularity, while another might require expert testimony. Third, some regimes might provide a menu of safe harbors that allow the parties to reliably signal their preference for having their contract interpreted by a particular sort of extrinsic evidence. Finally, some regimes might add presumptions to aid in justifiably inferring facts that are difficult or costly to determine. Thus, every incorporation regime will permit extrinsic evidence to be used to interpret contract terms only when a fact finder finds that the party with the burden of proof sustains its burden by offering admissible evidence satisfying the relevant standard of proof. But each regime can specify different fact finders, burdens of proof, standards of proof, safe harbors, and presumptions.

Article 2 explicitly or implicitly specifies the fact finder, burden of proof, standards of proof, safe harbors, and presumptions for the incorporation of extrinsic evidence. Article 2's core interpretive provisions are § 1-205(3) and its parol evidence rule, § 2-202. Section 1-205(3) states the order of priority given to different sorts of evidence in interpreting contract terms. It requires express terms to be construed as consistent with course of dealing and trade

usage "wherever reasonable."[30] Express terms control only when a consistent construction is "unreasonable." Fairly understood, § 1-205(3) gives priority to the plain meaning of term over trade usage, course of performance and course of dealing in such cases. Section 2-202 states what sort of evidence is admissible to interpret contract terms. The section instructs courts to allow trade usage, course of performance and course of dealing to "explain or supplement" the terms of even an integrated writing. Official Comments explicitly reject the "lay dictionary" and the "conveyancer's" reading of terms in commercial agreements.[31] Article 2 allows parties a safe harbor by which they can limit the sort of evidence used to interpret their agreement. They can do so by "carefully negat[ing]" any usage of trade, course of performance or anticipated course of performance they prefer not to have applicable to their deal.[32]

Article 2 relies on a mix of Code and extra-Code law to set the other elements needed for interpretation. Interpretation of contract terms is allocated the fact finder, except when the court finds a writing to be integrated.[33] The existence and content of trade usage, course of performance, and course of dealing also is left to the fact finder.[34] Article 2's definition of trade usage places a modest constraint on fact finding, requiring that it have a "regularity

---

[30]See U.C.C. §§ 1-205(1) (course of dealing), 1-205(2) (usage of trade), 2-208(1) (course of performance). The proposed revision of Article 2 increases the extent of incorporation by repealing current Article 2's interpretation of shipment terms. Proposed U.C.C. § 2-309 instead requires that shipment terms be "interpreted in light of applicable usage of trade, and any course of performance or course of dealing between the parties." Revision of Uniform Commercial Code Article 2--Sales § 2-309 (May 1, 1998).

[31]See U.C.C. § 1-205 com. 1.

[32]See U.C.C. § 2-202 com. 2; infra note .

[33]See U.C.C. § 2-202. Section 1-205(2) requires the court to interpret written trade codes when they are established to embody relevant trade usage.

[34]See, e.g., U.C.C. § 1-205(2); the allocation of issues of course of dealing and course of performance to the trier of fact is implicit.

of observance in a place." The associated Official Comment makes clear that only statistical regularity, not longevity, is required for a finding of trade usage.[35] Although Article 2 sometimes expressly allocates the burden and standards of proof,[36] it does not do so in the case of the interpretation of contract terms. Burdens and standards of proof therefore are implicitly left to extra-Code law, presumably applicable under § 1-103. The few presumptions that bear on the interpretation of contract terms, such as *contra proferentum* rules or the bindingness of trade usage on newcomers, are products of decisional law, not Article 2's provisions.

An accurate assessment of the incorporation strategy requires a clear distinction between the incorporation strategy itself and the many possible incorporation regimes that might implement it. Because the incorporation strategy does not require a single specification of any particular institutional element, many different incorporation regimes are possible. A criticism of one particular incorporation regime, therefore, does not by itself constitute a criticism of the incorporation strategy generally. A defect in one incorporation regime does not demonstrate that all other possible and feasible incorporation regimes are likely to have a similar defect.[37] Moreover, even if a criticism is effective against a particular incorporation regime, that regime might be amended to address the particular defect the criticism identifies. Thus,

---

[35]See U.C.C. § 1-205 com. 5.

[36]See, e.g., U.C.C. § 2-607(4) (accepting buyer has burden of proving nonconformity in goods tendered), U.C.C. § 1-201(8) (defining "burden of establishing").

[37] For instance, the UNIDROIT Principles for International Commercial Contracts includes trade usage as part of the parties' agreement, except when the usage is "unreasonable." *See* International Institute for the Unification of Private Law, UNIDROIT Principles for International Commercial Contracts art. 1.8(2) (1994). The exception in effect restricts the sort of extrinsic evidence relevant to interpreting the express terms of the parties' agreement. And, of course, the restriction is itself vague and therefore potentially increases the rate of legal error in interpretation. This might make UNIDROIT's implementation of the incorporation strategy a bad one. But this fact does not undermine the incorporation strategy generally.

because Article 2 describes just one way in which the incorporation strategy can be implemented, criticisms of it neither condemn Article 2 itself nor the incorporation strategy generally. After all, if Article 2 is subject to compelling criticism, it might be amended to avoid the criticism. The resulting interpretive regime might well be sufficiently similar to the original Article 2 regime that we would not say the criticism required abandoning the regime. More important, whether or not Article 2 survives its own amendment, the resulting regime might not only qualify as incorporationist but constitute a more thoroughgoing incorporationist regime than Article 2.

The incidence of the interpretive errors identified by the critiques we have considered can be significantly reduced by including a number of feasible provisions in incorporation regimes such as Article 2. The existence and informal norm critiques are each directed at interpretive error produced by faulty inferences from regularities in behavior, either under a contract or in similar contracts. The existence critique holds that trade usage sometimes or often does not exist where the incorporation strategy finds it. The informal norm critique maintains that courts sometimes or often fail to distinguish formal from informal norms, wrongly interpreting the contract to include norms not intended by the parties to be enforceable. Both critiques charge that incorporation induces courts to find commercial practice where there is none.

Under Article 2, the interpretive errors identified are the product of a trier of fact (or a court, if the agreement is integrated) drawing incorrect inferences based on particular sorts of evidence. These errors can be reduced by selecting a better decisionmaker or requiring that interpretation be based on more reliable evidence. Accordingly, a combination of a superior fact finder, superior evidentiary bases, or higher standards of evidence can be specified. As with any interpretive approach, a combination of devices are available to the incorporationist. Contract interpretation therefore could be allocated away from relatively inexpert, generalist trial courts or juries and toward specialist courts or merchant juries. The Delaware Court of Chancery illustrates the former possibility. The Court hears most of the corporate cases brought in Delaware, acts as a fact finder, and has a developed expertise in corporate

matters. It is well positioned (and motivated) to understand the background against which corporate matters appear. In the case of contract interpretation, such specialized courts are well positioned to understand when parties are likely to incorporate commercial practice and when not.[38] At the very least, they are better positioned than generalist trial courts or juries. Interpretive error thereby can be reduced by the choice of judicial interpreter.

Merchant juries are another possibility. They can be assigned the task of interpreting the terms of the contract, taking into account commercial practices of which they are familiar. In early drafts of Article 2, Llewellyn proposed a merchant jury.[39] The elimination of his proposal from the final version of Article 2 means that inexpert fact finders both find commercial practice and interpret the terms of a sales agreement in light of it. This sort of institutional design is not inevitable. Merchant juries, potentially familiar with the commercial practices in issue, arguably make fewer interpretive errors than lay juries. They are less likely to wrongly find trade usage, for instance, where none exists or a "thick" and detailed practice where there are only "thin" and sparse regularities of behavior. Merchant juries, potentially being industry experts, are less likely to mistake local trade usage for widely shared commercial practice. Certainly parties often select arbitrators familiar with the practices surrounding the transaction for which the parties have contracted. The reasons for doing so are complex and sometimes need have nothing to do with knowledge of the decisionmaker selected. However, the contracting parties' choice of arbitration is consistent with a preference for the interpretive advantage provided by an expert familiar with the relevant commercial

---

[38] *See* Rochelle C. Dreyfuss, *Forums of the Future: The Role of Specialized Courts in Resolving Business Disputes*, 61 BROOK. L. REV. 1 (1995); cf. Richard L. Revesz, *Specialized Courts and the Lawmaking System*, 138 U. PA. L. REV. 1111 (1990).

[39] See Allen R. Kamp, *Uptown Act: A History of the Uniform Commercial Code: 1940-49*, 51 S. M. U. L. Rev. 275, 292-93 (1998); James Q. Whitman, *Commercial Law and the American Vol.: A Note on Llewellyn's German Sources for the Uniform Commercial Code*, 97 Yale L. J. 156 (1987); Zipporah Batshaw Wiseman, *The Limits of Vision: Karl Llewellyn and the Merchant Rules*, 100 HARV.. L. REV. 520 (1987).

practices.[40] Merchant juries, which reduce the rate of interpretive error, make litigation a closer substitute for arbitration.

Restricting evidence, raising standards of proof, and adopting stronger legal criteria for commercial custom also can reduce interpretive error. If the existence critique is correct, regularities in industry practice are seldom pronounced or detailed enough to be trade usage. An appropriate response to such paucity of trade usage might be to restrict evidence of industry practice to written industry codes or corroborative testimony by industry experts.[41] This makes good sense given a general regulatory and contractual preference for conditioning obligations on verifiable variables. Alternatively, admissible evidence could be restricted to terms appearing in standard form contracts in the relevant trade.[42] Another response would be to require more regularity of commercial practice, both in scope and longevity. Pre-Code law apparently did this, by requiring that trade usage be "ancient or immemorial" and

---

[40] *See*, e.g., Julia A. Martin, *Arbitrating in the Alps Rather Than Litigating in Los Angeles: International Intellectual Property-Specific Alternative Dispute Resolution*, 49 Stan. L. Rev. 917, 926 n.45 (1997), A.W.B. Simpson, *The Origins of Futures Trading in the Liverpool Cotton Market*, in Essays for Patrick Atiyah 179, 183 (P. Cane & J. Stapleton eds. 1991).

[41] Although Article 2 in principle allows for expert testimony to establish the existence and content of commercial norms, it is surprisingly rare. *See* Imad D. Abyad, *Commercial Reasonableness in Karl Llewellyn's Uniform Commercial Code Jurisprudence*, 83 VA. L. REV. 429 (1997); Cf. Conference of Commissioners on Uniform State Laws, Report on the Second Draft of the Revised Uniform Sales Act, 1 Uniform Commercial Code *Drafts* 281, 335 (E. S. Kelly ed. 1984) (comment to § 1-D considering whether formal statements of usage by merchant organizations should create a presumption of the background of understanding of terms).

[42] The restriction risks error when the forms do not reflect changes in trade usage. Standard forms in the grain trade apparently are slow to react to changes in shipping practices; see Albert Slabotzky, Grain Contracts and Arbitration 15-16 (1984); cf. Raj Bhala, *Self-Regulation in Global Electronic Markets Through Reinvigorated Trade Usages*, 31 Idaho L. Rev. 863, 907-08 (1995) (same for currency "switches").

prevalent.[43]

The amendments to Article 2 that would be expected to reduce the interpretive errors identified by the existence critique would also be expected to reduce the interpretive errors identified by the informal norms critique. But the problems each critique identifies are importantly different. Whereas the existence critique calls for measures to insure that fact finders do not find custom where it does not exist, the informal norms critique calls for measures to insure that fact finders do not find formal norms where only informal norms exist. Thus, unlike the existence critique, the informal norms critique does not deny that there are regularities in commercial behavior generally, and in the contracting parties' behavior in particular, that reflect enforceable obligations. It notes that these regularities sometimes instead will reflect unenforceable obligations instead (informal norms). The problem therefore is not to design rules in the face of an assumed infrequent phenomenon such as formal trade usage. It is to design rules to induce the *accurate* detection of a frequent phenomenon: formal norms evidenced by usage of trade, course of dealing, and course of performance. If party-specific behavior is more likely to reflect informal norms than general commercial behavior, an incorporation regime might well assign different burdens and standards of proof to trade usage than for course of dealing and performance. For example, a bare statistical regularity might suffice to prove a formal usage of trade exists, while both a statistical regularity and expert testimony might be required to prove the existence of a formal course of dealing or course of performance.

Reduction of the interpretive errors identified by the encrustation critique requires altering another way in which the incorporation strategy is implemented. The critique speculates that the self-contained nature of Article 2 induces courts to rely on precedent interpreting Code provisions dependent

[43]See U.C.C. § 1-205 com. 5; cf. Levie, *supra* note ?.

on commercial custom and to ignore changes in that custom.[44] Because the tendency postulated is not irreversible, encrustation can be avoided by altering the way in which courts regard Article 2. Accordingly, the incorporationist response is similar to its other responses: altering the particular way in which Article 2 is implemented. A straightforward alteration is to make Article 2 even less self-contained by making it more reliant on extra-Code developments in commercial custom. It is common for treaties lacking a mechanism for centralized implementation to include provisions calling for national courts to interpret them with an eye to uniformity.[45] Article 2 could be amended in the same sort of way. It could contain an explicit injunction to courts to avoid relying on case law to determine trade usage, for instance. The injunction would help force them to gauge trade usage by looking to contemporary commercial practice. It more effectively vindicates the incorporationist strategy.

The variety of feasible ways of implementing the incorporation strategy means that it has resources to adjust to the presence of interpretive error costs.

---

[44] *See* Robert E. Scott, *Rethinking the Uniformity Norm in Commercial Law: Optimal Institutional Design for Regulating Incomplete Contracts*, this Volume. An alternative speculation is that encrustation is the result of doctrinal devices such as precedent or the taking of judicial notice about commercial practice. Encrustation may have no statutory genesis. For the operation of judicial notice of trade usage under pre-Code law, see Note, *Custom and Trade Usage: Its Application to Commercial Dealings and the Common Law*, 55 COLUM. L. REV. 1192, 1201, 1203 (1955); cf. Stoltz, Wagner & Brown v. Duncan, 417 F. Supp. 552, 559 (W.D. Okl. 1976).

[45] *See*, e.g., Convention on Contracts for the International Sale of Goods art 7(2), *supra* note ? ; UNCITRAL Model Law on Electronic Commerce, art. 3(2) (1997), U.N. Doc. A/51/628 (1996), Draft Uniform Rules on Assignment of Receivables Financing, art. 8, U.N. Doc. A/CN.9/WG.II/Wp.9323 (1997), Model Law on Legal Aspects of Electronic Data Interchange and Related Means of Communication, art. 3(2), U.N. Doc. A/CN.9/426 (1996), and UNIDROIT, UNIDROIT Convention on International Financial Leasing, art. 6 (1988), 27 Int'l. Legal Mat. 931 (1988), UNIDROIT Convention on International Factoring, art. 4, 27 Int'l. Legal Mat. 943 (1988), Proposed UNIDROIT Convention on International Interests in Mobile Equipment (Tent. Draft, Nov. 1997).

This is illustrated by specific strategies for pursuing incorporation that arguably *fail* to take interpretive error seriously. Robert Cooter, for example, proposes that courts proceed by identifying existing commercial norms and discerning the likely strategic structure of interactions in which the norms arise.[46] If the strategic structure of interactions tends to produce efficient outcomes, courts should use the commercial norms identified to interpret or supplement parties' contracts. By doing so, according to Cooter, courts need not inquire directly into the efficiency of contract terms or interpretation of them. Cooter's proposal arguably induces high interpretive error costs (as well as high administrative costs). Although courts need not inquire directly into the efficiency of terms, Cooter requires them to assess two variables: relevant commercial norms and the strategic structure of likely interactions. Because the variables are independent, the likelihood of judicial error is greater than if courts were directed only to identify commercial norms. Further, error in detecting the strategic structure of interactions probably is itself high. This is because the strategic structure of an interaction sometimes must include the way in which parties describe the array of payoffs and strategy choices. The mathematical structure of interactions, such as payoffs and strategy choices, are not enough always to explain equilibrium outcomes.[47] Because judicial access to parties' descriptions of their interactions is at best imperfect and can be gamed by parties in litigation, the interpretive error costs associated with Cooter's proposal are likely to be significant. Whether they are higher than the costs associated with directly inquiring into the efficiency of terms or their interpretation needs to be determined.

The proposal still might produce lower aggregate interpretive error costs

---

[46] See Robert D. Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643 (1996), *Structural Adjudication and the New Law Merchant: A Model of Decentralized Law*, 14 INT'L REV. L. & ECON. 215 (1994).

[47] *See* Robert Sugden, *A Theory of Focal Points*, 105 ECON J. 533 (1995), Michael Bacharach, *Variable Universe Games* 255, in FRONTIERS OF GAME THEORY (K. Binmore et al. eds. 1993).

than its competitors. If it does not, then, holding specification costs constant, Cooter's specific suggestion for incorporation of course should be rejected. However, the failure of the suggestion still leaves a range of other feasible ways of implementing the incorporation strategy. And they might well fair better by producing greater reductions in interpretive error costs. For instance, a variant on Cooter's suggestion recommends that courts only determine relevant commercial custom, rather than the strategic structure of interactions. By not requiring that courts detect strategic structures, a likely significant source of interpretive error is eliminated. The recommendation also clearly provides recognizable means of implementing the incorporation strategy. Even if unsuccessful, Cooter's proposal therefore is only one of a number of ways in which incorporation can proceed, and its rejection does not condemn the incorporation strategy generally.

The array of possible ways of implementing particular incorporationist strategies does not undermine their incorporationist character. Each implementation still requires that commercial practice informs the meaning assigned to contract terms. They differ only in how commercial practice enters in the interpretive process. Of course, devices such as burdens of proof have effects on whether contract terms will bear the meaning given them by customary practice. An assignment of burden of proof to one who wants to introduce trade usage, for instance, might make it more unlikely that trade usage will be considered in interpreting a term. However, the reduced likelihood does not mean that trade usage will not be successfully introduced. It will depend on whether the evidence is available to the party having the burden. Alternatively, a statutory menu of language which if used by contracting parties will be taken to make trade usage inapplicable is possible.[48] This limits without eliminating the circumstances under which commercial practice will be used. Certainly both approaches remain significantly different from plain meaning approaches to interpretation. According to them,

[48]Cf. U.C.C. 2-316(2) (statutorily described warranty disclaimer language sufficient to disclaim implied warranties of merchantability); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 Texas L. Rev. 51 (1992).

commercial practice is never relevant to interpret the plain meaning of contracts. Even impeccable evidence of relevant industry practice is to have no effect on interpretation. Thus, implementing incorporation by adjusting interpretive devices does not destroy the distinctiveness of incorporationist strategies.

V. Conclusion

Incorporation of commercial practice in contract interpretation is best suited to generalist commercial statutes or rules. Generalist commercial laws cover a wide variety of transactions among contracting parties having heterogeneous, transaction-specific preferences. In these circumstances, interpretative approaches must take into account both interpretive error costs as well as specification costs. The case here for incorporation in interpretation argues that an incorporation strategy optimally minimizes the sum of interpretive error and specification costs associated with contract interpretation. The argument rests principally on four sensible empirical assumptions. First, where party preference is heterogeneous, contracting parties face high costs in signaling to third parties their understanding of contract terms. Thus, specification costs are a variable that interpretive approaches cannot ignore. By interpreting contract terms according to commercial practice, the incorporation strategy saves parties most of the cost of having to signal the aspects of that practice they want applicable to their contract.

Second, despite the arguable lack of uniformity of trade custom at the turn of the century, contemporary local and national trade customs are likely to be quite extensive. Third, where norms exist governing heterogenous transactions covered by a generalist law, they are more likely to be formal norms, intended by the parties to be enforceable, than informal norms, not intended for enforcement. On the whole, formal norms are likely to outnumber informal norms because transactions cover both discrete and relational contracts, informal norms are unlikely to govern discrete contracts, relational contracts are unlikely to predominate discrete contracts, and even within relational

contracts, formal norms are likely to predominate informal norms. Thus, the rate of interpretive error in mistaking informal for formal norms probably is low. Fourth, error costs associated with interpreting terms in light of commercial practice can be reduced by adjusting the way in which incorporation is implemented. This means that mistakes due to bias against opt-outs of trade usage, misidentification of informal for formal norms, or identification of trade usage where there is none, can be reduced by altering burdens of proof, evidentiary bases and standards of proof, and the like. Adjustment of these elements to affect legal error rates therefore can be made, taking into account their effect on specification costs. In this way, marginal interpretive error and specification costs can be gauged so as to obtain optimal levels of both. The case for the incorporation strategy claims that, given these four sensible assumptions, aggregate interpretive error and specification costs are lower than under plain meaning interpretive approaches.

Empirical studies concerning the existence of trade usage or the rates of informal and formal norms in particular industries are important for incorporationists. In fact, they are essential to the incorporation strategy because they affect the way in which it is implemented. For example, the adjustment of standards of proof and evidentiary bases depends on the likely rates of interpretive error. Thus, if trade usage is mostly local or "thin," or if most norms in a particular industry are informal, as Bernstein's data might suggest, then raising a standard of proof or restricting evidentiary bases might be appropriate. Far from being incompatible with the incorporation strategy, empirical data about the rate of informal norms or the limitations of trade usage is necessary for an intelligent implementation of the incorporation strategy. At the very least, the data require that incorporationists be sensitive to interpretive error and specification costs. Our objection to the critiques of incorporation is not that they fail to identify possible sources of interpretive error associated with consulting commercial custom. It is that the critiques either ignore specification costs, which favor incorporation, or ignore the resources available to incorporation strategies to reduce the interpretive errors they identify.