JUDICIAL INTERVENTION AS RISK REDUCTION

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I. Introduction

Employing an economics-based consequentialist\(^1\) approach to contract interpretation (focusing on the prospective effect and the factors that might justify intervention) this Article attempts to identify the precise parameters of an optimal framework for contract interpretation. Such a framework would seek to maximize the gains from trade. The issue in interpretation is always, given the words the parties used, what is the best (surplus maximizing) interpretation of the parties’ bargain. Courts can achieve that goal by minimizing the interpretive risk\(^2\) that

\(^1\) Consequentialism is “[t]he view that the value of an action derives entirely from the value of its consequences.” Simon Blackburn, *Consequentialism*, THE OXFORD DICTIONARY OF PHILOSOPHY 77 (1994). Consequentialism views the process of common law adjudication, at least if that adjudication involves difficult cases, as one that decides the better rule by analyzing the “prospective effects” of a legal decision. The consequentialists include the law and economics scholars who put a premium on the *ex ante* incentive effects of legal rules, including the efficiency consequences. This approach differs from the deontics who put a premium on deciding the case in light of the “pre-existing rights and duties” created by the agreement. Jody S. Kraus, *Philosophy of Contract Law*, in THE OXFORD HANDBOOK OF JURISPRUDENCE AND PHILOSOPHY OF LAW 701 (Jules Coleman & Scott Shapiro eds., 2002). Deontics regard the focus on *ex ante* consequences as violative of Kant’s injunction to “treat persons as ends in themselves and not as means to an end.” *Id.*

\(^2\) For a discussion of the importance that minimizing interpretive risks should play in contractual interpretation as a source of welfare improvement, see Juliet P. Kostritsky, *Interpretive Risk and Contract Interpretation: A Suggested Approach for Maximizing Value*, 2 ELO\(N\) L. REV. 109 (2011). This article builds
parties face when they draft an express contract but fail to completely resolve all possible issues. They stop short in drafting so that the level of particularity in the language fails to resolve a later disputed matter. This Article uses a framework in which cost considerations predominate to identify realistic models of how parties bargain and plan for disputes in drafting their contracts. The models describe the probabilistic thinking of the parties, both with respect to the meaning of words and to the parties’ likely goals for contracting. These goals include the minimization of opportunism and other similar risks that might chill future contracting and the parties’ views on a judicial role in interpretation given the particular nature of the dispute. Based on conclusions from these cost-conscious models, this Article argues for a more expansive interpretive rule than textualism or formalism.

Textualism and formalism are terms of art describing the prime competitor frameworks to expansive interpretation. They encompass different intellectual frameworks to the interpretive enterprise. In the arena of constitutional and statutory interpretation, textualism suggests that the judge interpreting the words give primacy to and be bound by the specific language. Textualism does so in order to “limit the choices open to the judge,” to constrain discretion by the judge, and to mask the substantive choices that might be involved in the interpretation of a statute or a term. Sometimes formalism is associated with the related idea that law itself is a “closed system, within which judgments are mechanically deducible from the language of legal rules.” At other times

on the insights of that article but expands the focus to address (1) the connections between formalism and textualism in contract interpretation and legal realism, common law adjudication and statutory interpretation, (2) seeks to carefully delineate the different strands of thinking in textualist and formalist approaches to contract interpretation, (3) precisely identifies and critiques the assumptions underlying textualist and formalist approaches and offers a competing set of plausible assumptions (4) examines the impact of capturing the probabilistic thinking of the parties on contract interpretation.

3 Yair Listokin, Bayesian Contractual Interpretation, 39 J. LEGAL STUD. 359 (2010).
5 Other scholars questioning the formalist/textualist approach to contract interpretation include: James Bowers, Contract Interpretation for Clairvoyant Firms Without Histories (unpublished manuscript on file with author) and Shawn Bayern, Rational Ignorance and Closed-Mindedness, and Modern Economic Formalism in Contract Law, 97 CAL. L. REV. 943 (2009).
6 Frederick Schauer, Formalism, 97 YALE L.J. 509, 521 (1988).
7 Id. at 513 n.9.
8 Id. at 522. See infra note x (discussing Formalism as it was critiqued by the legal realists).

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and in other contexts, formalism is associated with limiting the range of evidence that a judge may consider in construing words and with the specific exclusion of contextual clues to interpretation. By contrast, purposivism, contextualism, and consequentialism all challenge the idea that words can or should be interpreted without consulting either the overall purpose of the parties, a wide range of extrinsic circumstances or the consequences of adopting a particular interpretation. The explanatory theory offered here based on minimizing the costs to parties when residual uncertainty in a contract remains may explain the disparate “microdata—doctrines and decisions” of the contract law governing interpretation, gap filling, and construction. The decision on an interpretive rule should depend on which approach best reduces costs and would be most preferred by parties "ex ante."
A contract begins with express terms. If all contracts were complete and precise, and the exact way in which the express terms were meant to settle any later arising controversies were obvious, a court’s role would necessarily be limited. However, because even carefully drafted contracts involving commercial firms fail to deal with all possible contingencies or the language used may be intractable, questions about a possible role for courts may arise when parties sue on such contracts. Suppose, for example, that a contract designates an agent to use a trademark to sell products and to receive a designated percentage for any sales. Is that agent entitled to that percentage for licensing when the company enters into a joint venture and sells the entire business, including the trademark, to another entity? Such a contract does not

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17 See George M. Cohen, Interpretation and Implied Terms in Contract Law, in ENCYCLOPEDIA OF LAW AND ECONOMICS (2d ed.) (forthcoming), available at http://ssrn.com/abstract=1473854 (noting that generally if a contract is complete “there is no efficiency-enhancing role for a court other than to enforce the contract according to its terms.”)

18 Intractability may arise because the express terms, while clear when considered individually, lack clarity when read together. See United Rentals, Inc. v. Ram Holdings, Inc., 937 A.2d 810 (De. Ch. 2007). In United Ram there were two clauses in the contract that called for judicial interpretation. One clause entitled the company selling its assets to specific performance of the contract, while the other clause stated that a walk away/termination fee was the seller’s exclusive remedy in the event that the buyer did not close the deal and the specific performance clause was made subject to the clause making the termination fee the seller’s exclusive remedy. Id. at 815-19. This case is discussed in Gregory M. Duhl, Conscious Ambiguity: Slaying Cerberus in the Interpretation of Contractual Inconsistencies, 71 U. PIT. L. REV. 71 (2009). Questions may also arise when parties draft carefully to deal with some risks but fail to contemplate other risks which later arise. See Kostritsky, supra note 2. Analogous difficulties of intractable meaning may arise in the interpretation of statutes. To address such difficulties, some have embraced a uniform interpretive method. A recent article detailing the efforts of some state courts to adopt an interpretive methodology with the force of stare decisis. See Abbe R. Gluck, Laboratories of Statutory Interpretation: Methodological Consensus and the New Modified Textualism, 119 YALE L.J. 1750 (2010); see also Molot, supra note 11, at 3 (discussing the “convergence” between textualism and purposivism, and urging textualists to recognize the “consensus”). But see Ethan J. Leib & Michael Serota, The Costs of Consensus in Statutory Construction, 120 YALE L.J. ONLINE. 47 (2010) (explaining disadvantage of uniform approach to statutory interpretation and examining advantages of more variegated approach).

19 See Cohen, supra note 17, at 2 (noting that no contract actually describes all possible contingencies and explicitly provides a response for each contingency, and thus “no real-world contracts are fully complete in this sense”).

20 Beanstalk Group, Inc., v. AM Gen Corp. addressed precisely that issue. See infra note 129 and accompanying text.
cover the matter despite seeming to address the trademark issue with particularity.\footnote{A case such as the licensing case raises the difficult interpretive issue of when a court, confronted with interpreting a particular word or phrase, should ever invoke another interpretive principle. As Fred Schauer’s insightful article on Formalism explains, often a court faces a “choice . . . between two different norms.” Schauer, Formalism supra note 6, at 516. So in interpreting a phrase such as a law requiring that primary petitions be filed by 5:00 p.m., the court had to apply that law in the context of a case in which the clerk had misled the petitioner into believing that an actual personal appearance was necessary, which caused the petitioner to miss the deadline by three minutes. When determining whether a law requiring a filing by 5:00 p.m. would be met by a filing at 5:03 p.m., the court looked to another case in which equity refused to enforce a similar deadline since “reliance on erroneous actions on behalf of the State has put . . . its citizens in conflict with the literal terms of the time requirements instituted by that same sovereignty.” Id. Here there was a choice between a literal reading of the statute and an equitable interpretation from case law, but even when courts lack another case directly on point to lead them to apply one norm in a different context, the court must confront whether there are any other principles (such as an equitable principle limiting the reach of a strict rule when the party seeking to enforce it has contributed to its violation) which might alter the result of a rigid law.}

Or suppose that a contract addresses an issue explicitly: no three wheeled ATVs allowed on the land. The contract completely specifies precisely what type of vehicles are banned. If the future contingency of the development of new four wheeled ATV’s is accounted for, however, the express terms begin to seem incomplete.\footnote{That choice—to apply principles which might call for a different result than the one the language read in isolation would suggest is inevitable—exists even in the context of what at first appears to be just an interpretation of language calling for a literal application of the law. In that way, a formalist insistence on interpreting just the language might mask the underlying inescapable choices that judges have to make routinely, as when they decide that what appears to be a simple case is really more complex because of some other principle that the judge himself must identify. Id. at 517. This is the kind of choice faced in Jacobs & Young v. Kent, discussed infra Part VII.A. The court had to decide if the case was one involving the interpretation of language in a contract as an express condition or whether the court should decline to give effect to the language because of another competing principle—the anti-forfeiture norm.}

\footnote{See infra Part VII.B (discussing the interpretive issue involved in the ATV case). Broad interpretation means using a justificational framework that invokes the pursuit of chosen consequences, such as minimizing the \textit{ex ante} risk (costs) facing parties who use express terms—the consequence sought being to}
When such interpretive issues arise, courts may confine themselves to ascertaining the parties’ actual intent. If the parties have formed no actual intent on the disputed matter, an approach based only on the language is likely to be unproductive. Even if the parties formed an actual intent, the language may not reveal that meaning to a court. For example, the intent could be encapsulated in language that is unclear or fails to resolve whether a precise term was meant to apply in all circumstances (are there any exceptions) or whether the parties intended to have the language apply even if it would result in losses for both parties. Thus, the court has to “give[] meaning to the symbols of expression used by another person.”

Courts may resolve interpretive disputes in several ways. If the contract has express terms that seem to address the controversy but leave certain matters on which the dispute turns unresolved, a court may adopt an interpretive approach that looks beyond the express terms to decide meaning. Alternatively, the court might decide not to intervene beyond implementing the literal terms. Such a strategy may leave a party requesting relief without a remedy. If a contract pegs the price at the
“delivery date” but does not specify whether that date means “scheduled” or “actual” delivery date, the party whose case depends on persuading a court of a particular meaning may lose if the court adopts an interpretive rule which excludes many matters beyond the text since the text itself is inconclusive: there is no literal or formalist meaning of “delivery date.”

Where there are multiple possible meanings of the language and the text addresses but does not resolve the matter, a court should choose a meaning and justify its choice of an interpretive rule. Similarly, if a contract has two clauses that offer conflicting solutions, and if each side posits a different interpretation, one based on the literal text and one based on extrinsic matters, the court will necessarily choose an interpretive rule if it decides the case in favor of one party. On the other hand, if the express terms do not even seem to address the matter, a court

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28 *See infra* notes 135-43 and accompanying text. Where the text “delivery date” is inconclusive for either side, textualism does not provide a solution.

29 Textualists would admit the parties’ pleadings and briefs, a dictionary, and the judge’s life experience so they would contend that textualism should not be confused with literalism. Schwartz & Scott, *Redux, supra* note 27, at 933 (admitting that “literalism is impossible” since courts necessarily see the pleadings and briefs).

30 Once the text is found to be inconclusive, one option would be to treat the text as containing a gap. In fact, that an interpretive question has arisen suggests the “written contract contains some gap.” Bayern, *supra* note 5, at 958. The formalists, however, suggest that if the contextual evidence consisting of the life experience of the judge, the text, and the context of the transaction (as for example reflected in the company’s business plan) (Schwartz & Scott, *Redux, supra* note 27, at 952) does not resolve the matter, the court is faced with a choice: “to dismiss on the ground that the contract is too indefinite to enforce, or to read the contract to reach a reasonable result.” Schwartz & Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 609 (2003) (hereinafter *Limits*). Schwartz and Scott write that courts refuse to enforce contracts on grounds of indefiniteness more often than conventional wisdom holds. *Id.* at 609 n.145. Refusing to enforce can pick a winner just as easily as using a gap filler.

31 The case of *Frigalment* involves this kind of ambiguity as the text did not resolve whether “chicken” meant broiling or stewing chicken. *See Frigaliment Importing Co. v. B.N.S. Int’l Sales Corp.*, 190 F. Supp. 116 (S.D.N.Y. 1960).

32 *See supra* note 18; United Rentals, Inc. v. Ram Holdings, Inc., 937 A.2d 810 (De. Ch. 2007).

33 *See infra* *Beanstalk* case discussed at note 129. *See also* Listokin *supra* note 3, at 364 (“[C]ontractual gaps and ambiguities are part of a continuum rather than different modes of analysis.” One type of contextual evidence could include knowledge “of the prior likelihood (the base rate) that any pair of parties have one possible intent relative to the other possible intent.”).
has to decide whether to imply a term into the contract.\footnote{It may be difficult to determine whether the court is “interpreting” a term or “filling a gap.” As Professor Cohen explains, “Interpretation and implied terms are closely related concepts. For example, if the question is whether to read in an exception to an express term, such as a price or quantity term, that could be viewed either as an act of interpreting the express term or of implying an additional term (the exception).” Cohen, supra note 17, at 1 (emphasis added).}

These types of scenarios seemingly raise distinct doctrinal issues of (1) interpretation and (2) implied terms (gap filling), yet under an economic approach they may be linked analytically.\footnote{See Cohen, supra note 17, at 2 (stating that the legal issue addressed by interpretation and intervention is “whether one or more parties have performed as the contract requires, or have breached”). Judge Posner distinguishes implied terms and interpretation of express terms but then concludes that they are linked since “[g]ap filling and disambiguating are both, however, ‘interpretive’ in the sense that they are efforts to determine how the parties would have resolved the issue that has arisen had they foreseen it when they negotiated their contract.” Richard Posner, The Law and Economics of Contract Interpretation, 83 TEX. L. REV. 1581, 1586 (2005). See also Bayern, supra note 5 at 958 (“The general interpretive problem that courts face is not different for gaps and for ‘interpretive’ questions . . . .”). For other examples linking gap filling and interpretive rules, see Charles J. Goetz & Robert E. Scott, The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms, 73 CAL. L. REV. 261(1985).} In each instance, a court must choose a framework for deciding what interpretive approach would improve welfare,\footnote{The Uniform Commercial Code exemplifies the broader, contextualized approach. See, e.g., U.C.C. Section § 2-202 cmt. 1 (rejecting “premise that the language used has the meaning attributable to such language by rules of construction existing in the law rather than the meaning which arises out of the commercial context.”).} either a textualist or formalist rule or a broad approach to interpretation which uses a wide range of evidence in conjunction with a consequentialist analysis assessing the economic goal of minimizing interpretive risk\footnote{Of course, if the court is filling gaps they cannot resort to a method based on ascertaining the parties’ actual intent as it is reflected in the language.} or in the form of a law-supplied term—allowing a judge the discretion to depart from a rule giving exclusive primacy to the language of the contract.\footnote{The textualists and formalists want to deny that there is any real choice by highlighting the constraints of the literal text. Formalists in statutory interpretation follow a similar approach by seeking to mask substantive choices “as definitionally incorporated within the meaning of a broad terms” resulting in the appearance of “linguistic inexorability.” Listokin, supra note 3, at 512.} In every case, the court’s treatment of the express terms or its decision that the contract has gaps amounts to an interpretive rule.\footnote{See Cohen, supra note 17, at 3 (stating that even finding an express term is a}
the interpretive rules must be justified in consequentialist terms of maximizing value and minimizing costs, since enhancing those goals

“catchall,” meaning it applies in all circumstances with no exceptions “is itself an act of interpretation that requires justification”).

41 Professor Robert Scott and I certainly agree that the court should only intervene in contracts if doing so will increase the gains from trade and that courts should be guided by that ultimacy in interpreting the contract language. However, because Professor Scott thinks that courts have erroneously resorted to equity to revise contracts while interpreting their terms, he would rule out a number of elements that have comprised broad approaches in interpretive methodology. He would, for example, exclude all consideration of the parties’ contractual ends in favor of an interpretive method that adheres only to the contractual language unless the parties specifically delegate equity authority to the court. Kraus & Scott, supra note 27, at 1026. If Scott intends to rule out resort to equity as part of a formalistic interpretive approach unless it is specifically invoked by the parties, I respectfully disagree, at least if it would rule out a resort to equity to excuse express conditions that would cause forfeiture as in the Jacob & Youngs v. Kent case. See infra Part VII.A. Moreover, if Professor Scott means to rule out invoking concepts of reasonableness when interpreting terms unless the parties have specifically delegated equity authority to the courts, I would disagree and suggest that such an approach would negatively affect welfare improvement.

I respectfully disagree on several grounds. I would argue that because even sophisticated commercial parties may well assume that courts are free to interpret their contracts unless the parties clearly say otherwise, courts would be upsetting parties’ expectations if they restricted themselves to the formal precise contract terms unless the parties specifically authorized a departure from such terms. Second, to the extent that the Scott approach seems to rule out a consideration of the parties’ contractual ends in entering the contract, I would dissent in part. While it may be unwise, as Kraus and Scott argue, for the court to resort to a wholesale revision of contractual terms to achieve ex post fairness (because it might lead to inefficient outcomes that would cause future parties to shy away from contracting or impose higher costs on their counterparties to compensate for the risk of ex post revision), courts should be free to intervene with a broad contextualist interpretation or with an implied term if the court is convinced that doing so will lead to welfare improvement going forward.

If Kraus and Scott are merely suggesting that contextualist and consequentialist approach courts should not intervene at all with implicit terms, or should not interpret terms broadly to promote exchange unless specifically authorized to do so, then I disagree. If, on the other hand, Kraus and Scott are suggesting that courts should not engage in wholesale revision of contractual terms to achieve ex post fairness, I would agree, at least if a court is convinced that the ex post revision is not also an efficient outcome. Without that assurance, the intervention would be later overturned by the parties. Finally, while formalist and textualist scholars have been building arguments against contextualist and other broader approaches to interpretation, they have focused their objections on different components of a broad approach. They object to
will promote growth and wealth. \textsuperscript{42} Ideally, a court would use its judicial expertise (or business sense) \textsuperscript{43} with a model of incentives and human behavior to determine which approach would best facilitate future exchange and reduce drags on trade, including the hazard of opportunism. \textsuperscript{44}

Resolving the normative choice of the correct interpretive method has proved extremely controversial, even among scholars who agree that the goal of legal rules should be to maximize gains from trade and to minimize the costs and frictions of transacting. \textsuperscript{45} The formalists argue that courts concerned with costs and the economic goal of adding value should employ only formalism or textualism when they interpret contracts, ignore parties’ objectives, \textsuperscript{46} and exclude a great deal of

the resort to equity, the introduction of trade usage, contract negotiation, and course of performance evidence, and the resort to parties’ goals in contract interpretation.

\textsuperscript{42} See supra note x. This article therefore makes cost a central component of the normative analysis of contract interpretation. If a court were to adopt an interpretive method that raised costs, parties would opt out of such rules. In settling on an interpretive method to reduce costs, courts could consider what the efficient term would be or what the hypothetically preferred term might be. See Posner, supra note 36, at 1590 (detailing the costs and benefits of these approaches). Cf. STEVEN J. BURTON, ELEMENTS OF CONTRACT INTERPRETATION (2009).

\textsuperscript{43} Posner, supra note 36, at 1605.

\textsuperscript{44} The threat of opportunistic behavior and the need to devise means to reduce opportunism remain central to facilitating exchange. Because opportunistic parties will seek to use court interpretations to their own advantage and to the disadvantage of the other party and the integrity of the original bargain, the court must remain sensitive to such concerns in devising an interpretive methodology. Neither textualism nor contextualism should be adopted as an invariant strategy since that would limit the courts’ effectiveness in reducing opportunistic behavior. For an argument that textualism best reduces strategic behavior, see Schwartz & Scott, Limits, supra note 30, at 584.

\textsuperscript{45} OLIVER WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 17 (1985) (advancing the “proposition that the economic institutions of capitalism have the main purpose of economizing on transaction costs”).

\textsuperscript{46} Professors Kraus and Scott use the ALCOA/Essex contract to illustrate that objectives of the parties should be ignored by courts who interpret language. See Aluminum Co. of Am. v. Essex Grp., Inc., 499 F. Supp. 53 (W.D. Pa. 1980). In that case the court found that “the parties’ objective is to provide Seller a 3% profit.” The parties drafted a clause that pegged the price to an amount that was 3% above a particular industry index, but the index failed to function as planned due to unforeseen economic variables. Scott and Kraus would want courts to ignore such objectives in contract interpretation even if the contract, as written, fails to achieve the parties’ objectives. However, the notion that there are
contextualized evidence in the interpretive process. The modern formalists justify the narrower approach based on an analysis of parties’ preferences as they are expressed in the contract and as they are hypothesized to be based on a rational choice analysis that suggest commercial parties would usually prefer a minimum evidentiary base. They are making an *ex ante* argument that we have to honor the terms used by the parties *ex ante* and also honor their interpretive choices because that is not only faithful to what the parties intended it is the only way of maximizing the gains from trade. Intervention costs (the cost of mistaken interpretation) outweigh the benefits. One key assumption is that if the parties wanted broad interpretation, they would write that into their contracts. For reasons I will explore in the Article the costs of bargaining often make that assumption unreasonable. The parties often use words with the belief that they have identified the object of contracting with enough particularity and may never anticipate that a particular term will require interpretation. The parties often do not make *ex ante* choices over the proper role for courts since parties would not specific contractual goals shared by both parties is misguided. Instead, each party has a different project in mind with a projected payoff in the form of a future return stream, individual to that party. However, the absence of shared objectives for a particular project does not negate shared goals that cut across all contracting, including a desire to maximize wealth and minimize transactions costs.

The contextualized evidence that would be excluded by the formalist/textualist approach includes trade usage and prior negotiations, contextualized evidence that is currently permitted by the Restatement Second of Contracts, and the Uniform Commercial Code. (Cite to Restatement Second and to 2-202 of the UCC comment 2.) Those taking a narrow approach to context evidence would exclude trade usage unless the parties have specifically indicated that they want trade usage (non-ordinary meaning) to govern their contract. The textualist/formalists would change the current default rule by setting the linguistic default at ordinary meaning. Schwartz & Scott, *Limits*, supra note 30, at 585. The exclusion of the parties’ objectives, together with the exclusive focus on the express terms, seem to also rule out considering the consequences of various interpretive rules and thus also reject consequentialism as an interpretive methodology. See infra note x. Although the authors Kraus and Scott do not specifically negate consideration of consequences of interpretation, because they do rule out considering the parties’ contractual objectives and forbid a court looking beyond the express terms without specific delegation, one can surmise that the authors also intend courts to refrain from weighing presumed jointly shared economic goals in contractual interpretation. This Article suggests that courts must consider what is “more or less common and durable . . . in the behavior of individuals, acting alone or collectively” in contract interpretation. Ronald J. Coffey, Methodologies 14 (August 12, 2002) (unpublished manuscript) (on file with the author).

even see the need to choose an interpretive method; the need for it is simply not on the parties’ radar screen. Thus, for example, parties bargaining over the sale of a pencil may well assume that the color does not matter and thus would not matter and thus would not see the need to choose any kind of interpretive method. Yet, if the contract specifies “pencils” and most parties are indifferent to color, and the buyer insists on red pencils, a textualist insistence on narrow approaches to interpretation won’t help the seller who will have to accept the off the shelf rule of narrow approaches to interpretation. Thus, the argument can be made that the new textualists are decreasing surplus by requiring the parties to bargain over a term (whether to allow ex post interpretation) that raises transaction costs in a way that may preclude bargains or make them more costly. This Article questions the assumptions underlying the purported choice of the parties. There is a spectrum of opinion on how much weight to give to the text of the contract, how much outside contextual evidence should come in and at what stage, whether such evidence should be incorporated as part of a default rule (or as a mandatory rule) and what a party needs to include in the contract to permit the court to consider contextual evidence in a variety of forms.

By contrast, the consequentialist rule advocated in this Article announces in advance an interpretive rule that adds terms or broadly interprets terms using a variety of contextual evidence, if doing so will maximize gains from trade and minimize transaction costs based on an analysis of chosen consequences, such as the interpretive risk associated with leaving a contract incomplete and the control of contractual hazards.

The court’s decision about whether to apply broad or narrow approaches must be built on a factual model using the probabilistic thinking of parties to establish parties’ expectations about the role of the court in interpretation and to assign meaning. It must be built on realistic assumptions about how parties bargain and draft contracts and an assessment of how likely parties are to craft language that perfectly captures meaning. Courts should also consider whether parties are likely

49 Schwartz & Scott, Limits, supra note 30, at 609-10. Professors Schwartz and Scott posit that current default rules are mandatory and paternalistic since they overlook party choice. However, because the test for party choice sets a high bar for expressly opting into expansive interpretation with silence plus the use of specific terms amounting to an opt out, there may be no party choice to begin with except in the view of the formalists. Thus, a court supplied interpretive default rule may not be mandatory at all and may not paternalistically override party choice if such a choice does not in fact exist.
to be ignorant or cognizant of the law and how, if at all, they would change their crafting strategy in light of projected court decisions.

Formalists and textualists assume that a broad interpretive rule will necessarily contravene majoritarian preferences of commercial parties. For the formalists a “broad” approach might well admit certain types of evidence of context, such as prior negotiations, trade usages, course of dealing, and course of performance. Broad interpretation, if defined as the willingness of a court to look beyond express terms so that the term or the contract makes sense from a business perspective, might also be considered. A court might ask whether a proffered interpretation and the discretion to reject unreasonable interpretations would promote exchange by deterring opportunistic behavior and reducing costs, even without a specific grant of authority to do so. Current doctrines permit a court to avoid unreasonable interpretations without any specific delegation from the parties. A broad non-textualist approach would also consider the wealth/welfare consequences of a particular interpretation in a case.

If a particular approach would prompt parties to undertake costly protective measures in order to avoid nonsensical results that a court would easily reject if they were deemed to have discretion in interpretive approaches, even without specific delegation, that result should be avoided. This latter meaning of broad interpretation has been neglected by the textualists, yet it remains at the heart of many of the cases that reach beyond the literal text. Courts regularly depart from a universal rule of textualism to avoid negative welfare effects. These judicial

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50 This article therefore suggests that even sophisticated commercial parties may vary in the degree to which they are cognizant of the relevant law of interpretation.
51 See Schwartz & Scott, Limits, supra note 30, at 569 (“Typical firms prefer courts to make interpretations on a narrow evidentiary base whose most significant component is the written contract.”).
52 Id. at 572 (detailing components of broader evidentiary base).
53 Although Scott asserts that the “life experience of the judge” would enable a court to use its business sense in deciding contract interpretation issues, Schwartz & Scott, Redux, supra note 27, at 952-3, the usefulness of such life experience may be limited. It might allow a judge to decide that a structure to be built for a chemical company to store dangerous materials would not be satisfied by a construction of a gazebo, id., but it might not specifically empower a court to make other decisions, especially if the life experience of a judge is not specifically conceptualized to include consideration of the wealth effects of a certain interpretation.
55 For an extended argument against a unitary textualist approach to interpretive issues, see Juliet P. Kostritsky, Plain Meaning vs. Broad Interpretation: How
departures from a “grand theory” of formalism or textualism may demonstrate the superiority of a variegated, nuanced approach that assesses the wealth consequences of a particular decision on a case by case basis. By looking at the actual results of cases, this Article follows the injunction of the “law in action” intellectual methodology. Courts depart from textualism or formalism—if such an approach would lead to

the Risk of Opportunism Defeats a Unitary Rule for Interpretation, 96 Ky. L.J. 43 (2007-2008). See also Adam Badawi, Interpretive Preferences and the Limits of New Formalism, 6 BERKELEY BUS. L.J. 1 (2009). Badawi suggests a departure from a unitary approach to selecting an interpretive approach and argues that that court should consider the frequency of the transaction as a relevant factor in deciding whether contextualism or formalism should govern. Badawi argues where transactions are frequent and in standard goods, formalism may be more appropriate since the parties can easily draft complete contracts; where transactions are infrequent, drafting obstacles may be greater and contextualism a more appropriate method of interpretation.

This Article suggests that frequency may be a relevant but not dispositive factor. In many goods cases, the frequency and repetition of a transaction can lead parties to rely on usages and customs which they see no need to incorporate into the formal contract. Those practices are assumed to be incorporated without the need for formal language. Thus, the determinative factor should be the wealth effects of a formal versus contextualist interpretive method.


Professor Cohen notes that one advantage of this judicial approach is that it may “provide necessary flexibility. . . that an incomplete contract otherwise lacks.” Cohen, supra note 17, at 4. For a view that a multiplicity of interpretive approaches might be best, in the statutory interpretation context, see Leib & Serola, supra note 56, at 48 (citing “underappreciated benefits that result from methodological diversity”).

The law in action methodology is associated with particular scholars such as Stewart Macaulay, Marc Galanter, and William C. Whitford, and with the Wisconsin Law School. Macaulay’s path breaking article on the way in which businessmen often ignored the governing contract and avoided litigation in favor of working disputes out with one’s contractual partner caused people to rethink the importance of how contract law actually affected the operations of businesses. See e.g., Stewart Macaulay, Non-Contractual Relations in Business: A Preliminary Study, 28 AM. SOC. REV. 55 (1963). For a recent treatment of this methodology, see STEWART MACAULAY ET AL., CONTRACTS: LAW IN ACTION, VOLUME I: THE INTRODUCTORY COURSE, available at http://ssrn.com/abstract=1776456.
catastrophic or deadweight losses for both parties\textsuperscript{59} or would promote opportunistic behavior,\textsuperscript{60} result in an interpretation at odds with good business sense,\textsuperscript{61} or would lead to any other consequences that would act

\textsuperscript{59} A recent case illustrating an example of when a court should justifiably depart from the express terms of a contract involves the recent acquisition by Dow Chemical of Rohm and Haas. A case could have been made that, on a projected basis, forcing the combination would have sunk both firms’ asset projects, resulting in a rather clear economic waste in a broadly social sense. Of course, the merger was completed and Dow seems to be handling the fusion well. But that was not the expectation when things went awry at Dow just before the deal was to be consummated. It seems that a court of equity would be justified in refusing to enforce the clause in the contract requiring specific performance, if doing so would have led to catastrophic losses for both firms. \textit{See Answer of Defendants at 25 Rohm & Haas Co. v. Dow Chem. Co.,} (Del. Ch. Feb. 3, 2009) (No. 4309-CC), 2009 WL 286591 (where Dow alleged that the acquisition would threaten “the very existence of both companies”). The case settled before the Delaware Court of Chancery resolved the issue of whether the court should depart from the express terms of the contract calling for specific performance. However, equity would be justified in refusing to enforce specific performance if doing so would have led to catastrophic losses for both firms.

Since the textualists put a premium is put on the parties’ choice \textit{ex ante} to select language which indicates whether or not they wish to invoke the principles of equity, then they would conclude that when the parties have not chosen to delegate equitable decisionmaking expressly to a court, a court should stay its hand and enforce the clause requiring specific performance. \textsuperscript{60} \textit{See} Kostritsky, \textit{supra} note 56, at 85-86 (opportunistic behavior from adherence to formal term). As Professors Scott and Schwartz have explained, their preference is for a different rule than exists in U.C.C. §2-202. “A plain meaning default rule that pressures the parties have written in the standard language.” Scott & Schwartz, \textit{Redux, supra} note 27, at 932. Thus, unless specifically invoked by the parties the ordinary plain meaning would govern. Parties would have to opt out by specifically invoking non-ordinary trade usages. \textit{But see} Jeffrey M. Lipshaw, The Bewitchment of Intelligence: Language and Ex Post Illusions of Intention, 78 Temp. L. Rev. 99 (2005) (rejecting “that opportunism is a problem of any import to be addressed.”

\textsuperscript{61} TKO Equip. Co. v. C & G Coal Co., Inc., 863 F.2d 541 (7th Cir. 1988) (holding that where a contract for construction equipment expressly provided it was a lease with an option to purchase, and also expressly provided that it was not the intent of the parties to create a security interest in such construction equipment, if said option to purchase was exercised, then such a contract was to be construed as a lease and not a sales contract with a security interest, because to construe it otherwise would allow opportunistic behavior by the parties to interpret the contract in whichever way best suited their interests at any particular moment).

In a recent exchange with the author, Professor Scott indicated that he would not disagree with the argument here that courts should invoke business sense in deciding cases. He indicated that such considerations would be invoked under the heading of “life experience of the judge” which would be part of the
as a drag on gains from trade. If the approach to interpretive risk outlined in this Article explains the case law and the doctrines better than formalism or textualism, it may constitute a more comprehensive explanatory theory.62

This Article argues that judges (with certain exceptions in outlier cases)63 are doing an excellent job of handling interpretive issues in a way that enhances value for the parties, even if the contours of their interpretive rule are not fully and consciously articulated. Judges enhance value in several ways. They control opportunism and diminish interpretive risk by interpreting contracts to incorporate trade uses that control such opportunism, as well as by interpreting express terms using an economic-based consequentialist technique and by directly supplying terms if doing so will curb opportunism and lower overall transaction costs.64 These cases demonstrate the unwillingness of courts to adhere to strict textualism or formalism more comprehensive if doing so would prevent them from (1) admitting a wide range of extrinsic evidence unless the parties clearly opted into such evidence, (2) considering minimum evidentiary base and thus would not be excluded by him or other formalists. E-mail from Robert Scott, supra note 27.

However, this Article suggests that in interpreting contracts, courts should specifically do so in order to constrain opportunistic behavior or reduce deadweight losses, and that would include interpreting contracts to excuse an express condition if it would lead to forfeiture. That is a result that Professors Kraus and Scott would clearly disapprove of. See Kraus & Scott, supra note 23, at 1095-1097. Yet, under the approach suggested here, courts should feel empowered to excuse a condition in order to reduce the potential drag on gains from trade that would result from a literal enforcement of the express condition.

62 The ability of an underlying contract theory to explain the case outcomes constitutes a hallmark of an economic approach to law. Jody Kraus explains that “economic theories tend to treat the outcomes of cases as the principal legal data for contract theory to explain and justify, accord primacy to the explanatory task of contract theory, and aspire to explain away, rather than explain, the conceptual distinctiveness of contract law.” Jody S. Kraus, Philosophy of Contract Law, in THE OXFORD HANDBOOK OF JURISPRUDENCE AND PHILOSOPHY OF LAW 689 (Jules Coleman & Scott Shapiro eds., 2002). The ability of a theory to explain actual case outcomes does not constitute a relevant indicator of a theory’s success in deontic theories. In contrast, deontological theories “tend to treat the doctrinal statements as the principal legal data for contract theory to explain and justify, accord primacy to the normative task of contract theory, and require that contract theory explain and justify the conceptual distinctiveness of contract law. Id.

63 Kostritsky, supra note 2, at 137-143 (discussing ALCOA case as an outlier case).

64 One such example is the law-supplied term in RESTATEMENT (SECOND) OF CONTRACTS § 45 option contracts limiting the power of an offeror to revoke an offer once part-performance has occurred.
equitable concerns such as the anti-forfeiture principle unless the parties invoked such principles, and (3) generally interpreting terms to minimize interpretive risks for parties if doing so was the least costly alternative. In these cases, the willingness of courts to intervene seems to be built on probabilistic assumptions about how parties assign meaning and parties’ expectations about court intervention absent any express delegation. If no express provision of delegation is included, courts make assumptions based on probabilities that most parties would want courts to avoid unreasonable results or results that would likely (based again on probabilities) add to transaction costs or chill exchange, even if the parties did not clearly signal their desire for such departures from the literal text.

The questions of how to interpret express terms, what kind of interpretive approach to adopt, when and whether to imply terms into contracts, and whether to look beyond the language and toward what end have potentially far ranging effects beyond Contract law; it may have implications for the interpretation of express terms in statutes, particularly when those statutory provisions govern a contract. The same wealth justification that determines what rules courts should announce ex ante to govern interpretive risk using an economic, consequentialist approach should also guide courts when they interpret sections of federal bankruptcy law. If an ambiguity exists in a federal statute which applies to private parties’ transactions, then a consequentialist interpretation—one that takes account of the ex ante effects on the willingness of parties to enter into exchange transactions in the future—should help determine the meaning, since that would directly affect the future creation of

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65 It may also have ramifications for the interpretation of the Constitution and the express words contained therein. Learned Hand grappled with whether and why to justify the principle that courts have the authority “to assert their primacy as interpreters of the authority of other ‘Departments.’” LEARNED HAND, THE BILL OF RIGHTS 18 (1960). Although there is no express provision which gives the judiciary primacy, Judge Hand determined that there had to be such primacy in order to assure the proper functioning of the government. Id. at 15. Judge Hand was therefore justifying an implication of the Constitution by reference to the negative consequences that would follow from a contrary interpretation, what he calls a “practical condition upon its successful operation.” Id.

66 Of course, wealth outcomes are not always determinative in reorganizations. Creditors are compelled to sit by while a reorganization is attempted, and they may well lose value if the plan fails. See the LTV chapter 11 proceedings. In re LTV Steel Co., 274 B.R. 278 (Bankr. N.D. Ohio 2001). In some instances societal interests are placed above the creditors’ interests. This Article argues that wealth outcomes should at least be part of the calculus in determining how to interpret bankruptcy statutes.

67 The extent to which interpretation matters should be resolved by reference to objectives as well as the “common good” has been the subject of great debate in
wealth in private transactions. The Chrysler and GM bankruptcy cases arguably failed to take account of those effects in sanctioning the use of the bankruptcy “sale” provisions. In so doing, the judiciary potentially increased the interpretive risk of all debtor/creditor agreements, thereby undermining the incentives of creditors to lend, raising the cost of borrowing for all borrowers, or distorting incentives by encouraging lending to weak unionized companies because of the potential for a government bailout.

Part II will explore the different strands of Formalism in Contract Theory. Part III of this Article explores the role of consequentialism and formalism in common law decision-making. Part IV explores why and when interpretative issues arise even in contracts with express terms. Part V proposes a cost benefit approach to crafting an intervention choice in the form of announced interpretive rules. Part VI uses existing case law and the Restatement of Contracts to demonstrate how significantly current law deviates from textualism and to suggest an economic welfare improvement explanation for the results. Section VII explores the implications of a consequentialist framework for statutory interpretation issues in the context of bankruptcy law. Part VII concludes.

II. Formalism in Contract Theory

The narrow approach to interpretation has been justified on instrumental grounds. Whether those instrumental arguments are persuasive will depend on an analysis of the costs and benefits of different interpretive approaches and complicated “empirial and predictive questions about the consequences for institutional
performance” 71 of different interpretive default rules. That analysis will proceed in Sections V and VI; however, we must first understand what formalism is. It has assumed a variety of forms. Early on, proponents of formalism embraced literalism, arguing that the best “strategy is for courts to accept the limits imposed by legal formalism and interpret the facially unambiguous terms of disputed contracts literalistically.” 72 The formalist approach would also shun both ex ante defaults and ex post adjustments. 73 More recently textualism has been equated with a strong adherence to the parol evidence rule, by “honoring merger clauses in fully integrated contracts and then applying the plain meaning rule together with the court’s understanding of the context of the transaction.” 74 Scott would apply that textualist default rule “only when the express terms of the contract are understood by the court to be clear

71 Adrian Vermeule, Interpretation, Empiricism, and the Closure Problem, 66 U. Chi. L. Rev. 636 (1999) (addressing difficulties of choosing an interpretive approach while the empirical questions remain unanswered).
73 Robert Scott and Alan Schwartz argue in their Limits article that the current approach to interpretation misguidedely sets the rule as a mandatory rule of contextualism. They view the rule as a mandatory one that paternalistically refuses to recognize party choice for a narrow approach excluding evidence. Scott & Schwartz, Limits, supra note 30, at 609-610. They view the failure of courts to respect merger clauses as an overturning of the parties’ choice for a non-contextualized approach.

However, Scott and Schwartz fail to recognize several points which undermine the assertion that a contextualized approach to interpretation is a mandatory one imposed by paternalistic courts which contravene party choice and undermines party welfare. First, to apply the parol evidence rule, courts must first decide how to interpret the meaning of the terms. Without that initial determination a court cannot decide if the extrinsic evidence contradicts or adds to the terms. To settle on a meaning of the term, courts do and “should, as part of the process of interpretation, welcome testimony concerning antecedent agreements communications, and other factors that may assist in indicating the parties’ original intentions.” MARGARET N. KNIFFIN, CORBIN ON CONTRACTS SECTION 24.11 (Joseph M. Perrillo ed., 1998). Second, the rejection of ex ante defaults is premised on a series of assumptions about presumed party preferences for a non-contextualized approach which are open to question.

Finally, the rejection of ex post adjustments by courts policing to bring about fairness too broadly rejects all ex post adjustments by assuming that all ex post adjustments would be inefficient interventions by courts. For an example of an ex post adjustment that would be efficient, see the discussion of Jacob & Youngs in which the court applied an anti-forfeiture principle to reject a literal reading of an express condition in a way that actually minimized an interpretive risk for parties and so would be consistent with efficiency, Part VII.A.

74 Email from Robert Scott, supra note 27.
and unambiguous on their face.”  

One perceived advantage is the ability to resolve a disputed matter by summary judgment and avoid trials. At still other times, the narrow approach rejects certain “interpretive rules” in Contract such as the one favoring promises over conditions. The interpretation of language using an anti-forfeiture principle encompasses another version of textualism which rejects “unconventional” use of doctrine. A final iteration of the narrow approach would exclude the parties’ contractual goals from the determination of contractual intent, and give primacy to the contractual language even if it undermines the parties’ goals.

Under these various iterations of formalist theories, the parties would be able to opt out of the narrow approach, as for example by a decision by “the parties expressly to signal ex ante their preference for more aggressive modes of interpretation of the contract terms.” However, if parties fail to signal expressly that a court should incorporate trade usages in the interpretation of a contract, they would be excluded. If the parties fail to delegate broad discretion to a court, as by invoking standards of reasonableness, then the court should decline to exercise discretion. Similarly, if the parties do not indicate ex ante that they want courts to depart from “formal contract doctrine,” then courts should decline to do so.

These arguments rely on a number of assumptions, some articulated and some implicit, which this Article will challenge. The logic of these various strains of narrow approaches to interpretive issues would seem to foreclose courts from using a consequentialist analysis to supply default rules, decide whether ambiguity exists to resolve

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75 Id.
76 Schwartz & Scott, Redux, supra note 27.
77 Kraus & Scott, supra note 23, at 1078.
78 Id. at 1047-48.
79 Id. at 1027.
80 Scott, supra note 73, at 851.
81 Scott and Schwartz advocate overturning of the current “contextualist linguistic default” embodied in the U.C.C. in favor of a linguistic default of ordinary meaning. Schwartz & Scott, Limits, supra note 30, at 584-5.
82 Kraus and Scott, supra note 23, at 1030.
83 Id. at 1032.
84 See Part V. For a recent article challenging some of the assumptions underlying the textualists’ arguments in contract interpretation, see Bayern, supra note 5. For a comparable critique of the assumptions underlying a textualist approach to statutory interpretation, see Eskridge & Frickey, supra note 56, at 340 (documenting indeterminacy in textualism).
85 See supra note 1.
ambiguity, or interpret ambiguous, vague, or incomplete contracts. In effect the textualist rule provides that a party whose interpretation depends on extra-contractual considerations will always lose, unless that party has expressly delegated interpretive authority to a court by using broad, open-ended language or unless the text is clearly ambiguous.

86 Ambiguity refers to a situation in which the precise meaning of express terms is unclear. Judge Posner refers to the process of deciphering meaning as one of “disambiguating” contracts. Posner, supra note 36, at 1589.

87 See Schwartz & Scott, Redux, supra note 27 (noting failure of courts to distinguish vague from ambiguous terms).

88 See Kraus & Scott, supra note 23, at 1030 (arguing that the use of “precise” terms demonstrates a choice by parties to “withdraw authority from courts” and to “direct them to enforce the formal obligations the parties have explicitly specified in advance”). It is not clear what good that directive would do when the meaning is unclear. Textualism operates differently when express terms appear to cover the situation but the parties offer differing meanings to the express terms. Textualism would lead courts to literally interpret the terms of a contract or to leave the matter unresolved if the terms are express but their meaning is unclear. Professor Scott has indicated that “when the disputed contract language is ambiguous, the differences between textualists and contextualists essentially disappears” since in those cases, courts can look to contextual evidence. Scott & Schwartz, Redux, supra note 27, at 963 n.94. The rule, moreover, would only apply if the parties had an integrated agreement which was clear and plain on its face. Scott email, supra note 27.

However, there are still differences between textualists and contextualists with how readily they are to resort to contextualist evidence. First, as Corbin and Traynor indicated, you really can’t know whether a text is unambiguous until you look at the context. Meanings may look “plain,” but if you know more about the trade, party negotiations, or other background information, words can suddenly take on a lot of different meanings. Thus, the willingness to look beyond the contract depends on an initial finding that the contract has no plain meaning and is ambiguous. That initial determination seems to foreclose more contextual evidence than would be the case under a Corbinian approach or a Restatement approach that finds that context evidence should be readily admissible without a prior finding of ambiguity. See RESTATEMENT (SECOND) OF CONTRACTS.

The remaining differences with the textualists can also be seen by reading the NYU article authored by Professors Kraus and Scott. In that article, the authors suggest that the selection of precise terms instead of vague terms means that the parties have chosen not to delegate discretion to the courts to fill in those terms, and the choice of a precise term should therefore cause the court to “enforce the formal obligations that the parties have explicitly specified in advance.” Kraus & Scott, supra note 23, at 1030. If this theory is applied to the headhunter case, see infra note 119, then it suggests that courts might well find that there was a precise term of payment for all names supplied and that it was meant to cover names supplied regardless of the means of transmission and that therefore no additional evidence would be allowed since there was no express delegation to a court of such interpretative authority.
Even when the text is ambiguous, the formalists and textualists would severely limit the type of context evidence that can come in. Therefore, it is not clear that courts could directly consult a cost/benefit analysis of consequentialism under the umbrella of the “life experience of the judge,” the broadest type of context evidence allowed by formalists.

Under the textualist/formalistic approach, a court should avoid exercising discretion unless the parties have delegated discretion. A court should also generally avoid adopting interpretive rules that invoke other norms, such as the one that tells a court to interpret a term as a promise rather than a condition. Moreover, to the textualists the inclusion of a precise term indicates a decision to “enforce the formal obligations that the parties have explicitly specified in advance.”

The textualists’ arguments depend on a number of assumptions which, when unarticulated, serve to mask the substantive choices being made by the scholars themselves. Once these assumptions are challenged, then the associated conclusion in favor of formalism becomes less certain. First, there is the notion that the very use of a precise term, and the avoidance of broad or vague terms, represents a

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The concession that when a “disputed contract is ambiguous, the differences between the textualists and contextualists disappear, and, of course, the court must look to surrounding context to recover the parties’ objective \textit{ex ante} intent[,]” Scott email, \textit{supra} note 27, at 2, suggests that if a term is ambiguous both textualists and contextualists would reach similar results on the decisions about admitting context evidence. However, it is important to note that the textualists would significantly restrict that context evidence and admit only the contract, the experience of the judge, a dictionary, the pleadings, and some business information. Thus, even though Scott says that under conditions of ambiguity, “the divide between formalist and antiformalist positions essentially disappears,” Schwartz & Scott, \textit{Redux, supra} note 27, at 963, there is still a divide in the type of context evidence being admitted. Formalists would still exclude course of performance and trade usage evidence, Schwartz & Scott, \textit{Limits, supra} note 30, at 592, and there is no indication that they would be willing to allow courts to interpret contracts in a way that minimizes the interpretive risk for the parties and reduces the danger of opportunism as a means of achieving the presumed goal of improving welfare.

\textit{Id.}

The contextualized evidence permitted by the formalist/textualist would consist of a “minimum evidentiary basis” consisting of “the pleadings and supporting briefs, evidence as to what the seller delivered, the contract, a recent 10 K SEC filing by the buyer (if any), and the life experience of the judge.”

\textit{See} \textit{RESTATEMENT (SECOND) OF CONTRACTS} § 227 (“In resolving doubts as to whether an event is made a condition of an obligor’s duty . . . an interpretation is preferred that will reduce the obligee’s risk of forfeiture . . . .”).

\textit{Kraus & Scott, supra} note 23, at 1030.
deliberate decision by parties to avoid the back end costs associated with vague terms. Kraus and Scott also subscribe to the view that the use of precise terms “reduce[s] legal obligations to bright line rules that specify the content of the obligations ex ante.”

The use of a precise term may reflect the parties’ certainty that the term was self-evident and would not require any later interpretation by a court. The formalists have themselves constructed and chosen a legal rule of interpretation that says that when parties use precise terms, they intended to foreclose any role for a court in discerning the meaning of the term. If one assumes that a matter, such as the advent of four wheeled ATV’s was unanticipated, the use of the precise term might reflect an unthinking, unreflective use of a word. The question of whether the parties intended to foreclose all future interpretation should depend on likely predictions about whether court intervention would interfere with goals that the parties are likely to embrace, such as the minimization of transaction costs and the curbing of opportunistic behavior. In some instances, the use of a precise term, such as a fixed quantity of material at a fixed price, might foreclose a court from intervening to incorporate trade usage that regarded fixed terms as mere estimates, if doing so would encourage opportunistic behavior by a party advantaged by price changes. However, in other cases, where a precise term such as one banning a three wheeled ATV fails to anticipate a change in technology, courts should expand the term to include four wheeled ATVs if doing so would achieve the parties’ original goals in banning all wheeled vehicles, regardless of the number of wheels.

The other strain of formalism that serves to limit the role of courts in interpreting contracts is one in which Kraus and Scott subscribe to formal contract doctrine, meaning “the formal rules of interpretation, in particular the parol evidence rule and the integration doctrines.” Formalists object when courts “apply[] the formal doctrines in an unconventional fashion.” They believe that courts err if they permit parol evidence of an oral condition despite an integrated agreement. In their view, the introduction of such evidence undermines formal doctrines, such as the parol evidence rule. They believe that the foundational premise for such judicial action—one that surmises that the intervention is necessary to facilitate rational ends of the parties—is flawed and undermines party choice. Formalists would also rule out the invocation of equitable considerations when the court is charged with

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93 Id. at 1030.
94 Id.
95 Id. at 1046.
96 Id.
97 Id.
interpreting a term, such as the wording of an express condition, unless the parties expressly authorize such equitable intervention.

The total ban on considerations of equity in the interpretation of contracts absent authorization should be rejected in favor of an approach in which the invocation of equity depends on whether courts can implement an equitable dimension in Contract law in a way that furthers the parties’ overall goals of maximizing gains from trade.

III. The Role of Formalism and Consequentialism in Common Law Adjudication and Contract Interpretation and Decision-Making.

To determine whether formalism should be the preferred default rule for the interpretation of contested contracts we must understand both the role that formalism has played in the separate and distinct arena of common law decision-making and the reasons why scholars and some courts later rejected it. The insights of legal realists into the deficiencies of formalism as a basis for common law decision-making should be relevant in deciding whether formalism or textualism or another methodology should prevail as the preferred default rule for contract interpretation.

Early adherents to formalism argued that goal achievement should play no role in legal decision-making. Instead, courts were to use a purely deductive process in which judges could work from the generality of law in the form of an expressly stated doctrinal rule to their application (or nonapplication) to a set of facts. David Hume

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98 Later scholars rejected and in fact developed “an aversion to formalism” rejecting the idea that “the language of rules either can or should constrict choice in this way.” Shauer, supra note 6, at 509.
99 These deficiencies have been well documented. See Matthew Stephenson, *Legal Realism for Economists*, 23 J. ECON. PERSP. 191, 197-98 (2009) (describing the inability of formal legal reasoning to accurately predict judicial decisions and claiming that there “may be relatively consistent, stable patterns in judicial decisions . . . that are captured neither by the formal rules nor by crude ideological measures”).
100 “Mechanical legal formalism holds that the ‘law’ consists of a collection of rules contained in a well-defined set of source materials—principally statutes,
demolished this notion by demonstrating that it was impossible for a
generality to tell which special cases were contained within it. A noun
cannot tell you what categories are included within the noun. The idea
that pure deduction can be used to work from a doctrine to its application
(or non-application) to facts that vary from those stated in the generality
of the doctrine has thus been rejected as impossible. It was therefore no
longer possible “to believe that every legal question has a right answer
that a properly trained lawyer or judge can deduce by correctly applying
the canonical legal materials to the facts.”

The legal realists relentlessly pursued the insights of Hume and
suggested that since doctrine alone would not predict what case outcome
should prevail, cases should be resolved by uncovering the policy
considerations that were operating in the cases at a sub rosa level.

The view that cases cannot be decided without a consideration of
the projected consequences of a legal decision prevailed and we are all
consequentialists now or we were until the recent resurgence of
formalism. We cannot imagine judges deciding the possession issue in
the famous property case of Pierson v. Post without at least
considering how the rule will affect those subject to it and how a
particular legal decision will further certain goals, particularly when
there are difficulties in applying the doctrinal categories centering on a
manipulable concept such as possession. Similarly, we cannot decide
what the legal test for an offer should be or whether silence should

regulations, contracts, and prior judicial decisions—along with a relatively small
number of fundamental legal concepts. At least according the pure version of
Formalism, every legal question has a right answer that a properly trained
lawyer or judge can deduce by correctly applying the canonical legal materials
to the facts of the case.” Id. at 193.

101 Conversation with Ronald J. Coffey, Professor Emeritus, Case Western
Reserve University School of Law. See also DAVID HUME, A TREATISE OF

102 Stephenson, supra note 99, at 193.

103 See, e.g., John P. Dawson, Duress Through Civil Litigation, 45. MICH. L.
REV. 571 (1945). See also Robert W. Gordon, Unfreezing Legal Reality: A

104 See David Charny, The New Formalism in Contract, 66 U CHI. L. REV. 842
(1999); Schwartz & Scott, Limits, supra note 30; Kraus & Scott, supra note 23;
Schwartz & Scott, Redux, supra note 27. But see Henry E. Smith, The Equitable
formalists and the consequentialists share welfare improvement as a goal, but
the new formalists argue that courts should pursue that end by honoring party
choice on interpretive method rather than consulting consequentialism to
interpret ambiguous language.

105 3 Cai. R. 175 (1805).
operate as assent without considering what the consequence of the test would be on the costs of transacting.\textsuperscript{106} In confronting whether an objective or subjective theory should govern the determination of an offer, courts consider the costs of a subjective approach given the difficulty of ascertaining a party’s unmanifested subjective intent.\textsuperscript{107} In postulating that the decision between two alternative rules should depend on the costs of transacting, the courts are certainly focusing on a key consequence of an interpretive rule for assessing whether an offer exists. Because courts do consider consequences in contract law when they choose what doctrine to apply, they should take the same approach in determining what rule should govern how ambiguous language in contracts is interpreted, whether to adopt an interpretive default rule of construction preferring a duty to a condition, whether and when to invoke equity, and what rule should govern the admissibility of extrinsic evidence.

However, when law and economics scholars consider how courts should interpret contested contracts, they curiously depart from the economic based consequentialist method they advocate for common law adjudication. They instead embrace formalism and suggest that the parties’ goals or objectives should play no role in deciding cases.\textsuperscript{108} They posit that if the parties fail to expressly adopt a rule delegating broad interpretive authority to courts,\textsuperscript{109} the parties intend to foreclose courts’ consideration of goals or anything else beyond the parties’ express language when interpreting contracts.\textsuperscript{110} They justify a narrow approach to interpretive default rules on the ground of party choice; the postulated choice is that parties prefer a narrow approach to interpretation on minimum evidentiary base of evidence without any consideration of equity.


\textsuperscript{107} The role of the objective test was “to create and maintain a framework of reasonably well defined and assured expectations as to the likely official and nonofficial consequences of private venture and decision.” IAN AYRES & RICHARD E. SPEIDEL, STUDIES IN CONTRACT LAW 235 (2008) (citing J.W. HURST, LAW; THE CONDITIONS OF FREEDOM IN NINETEENTH CENTURY AMERICA 21-22 (1956).

\textsuperscript{108} See Kraus & Scott, supra note 23, at 1026.

\textsuperscript{109} Professors Kraus and Scott explain “why sophisticated commercial parties . . . might prefer their future contracts to be adjudicated under a regime that applied formal doctrine exclusively unless the parties indicate otherwise at the time they form the contract.” Id. at 1032.

\textsuperscript{110} Id.
What remains hidden from the formalist scholarship is that in postulating a rule for how parties must express their choice if they desire a broader interpretive rule, the formalists appear to be merely implementing parties’ choices with a seemingly “linguistic inexorability.” Yet by imposing the duty on parties to opt-in and devising an interpretive rule to determine what suffices as an opt-in, the formalists have done so, relying on their own substantive choices. The decision about what rule to adopt in interpreting the parties’ language is itself a choice. There is always a choice about whether and when to apply the rule and there is often an “escape route” that a court may advert to avoid the application of a rule.

Formalists project negative welfare consequences if courts go beyond the parties’ express terms absent express delegation. Following Hayek, who projected obstacles to outsiders attempting to make improvements by intervening in a private exchange beyond implementing the spontaneous order, the new textualists have offered

111 Schauer, supra note 6, at 512.
112 Id. at 516.
113 They project a party preference for an interpretive strategy of plain meaning or formalism or textualism since it would “(a) reduce contracting costs; (b) expand the set of efficient contracts parties could write…” Schwartz & Scott, Redux, supra note 27, at 962 n.92 (citing Schwartz & Scott, Limits, supra note 30, at 584-94). By inference, a contrary approach would increase costs, increase errors by courts, increase opportunistic behavior and decrease efficient contracting. But see Posner, supra note 35, at 1587 (positing that in certain cases rigid adherence to textualism might, by “creating pressure for recognizing exceptions…reduce clarity.”) The formalist view, moreover, is premised on a number of assumptions including that of “competent parties and incompetent courts.” Scott, supra note 72, at 875. Other assumptions underlying the choice of a narrow preferred interpretive approach include the view adopted by Schwartz and Scott that parties are indifferent to risk and care only about courts getting the correct result on average. Schwartz & Scott, Limits, supra note 30, at 550 n.16, 577. That assumption has been questioned on a number of grounds. See infra note , (discussing the competing idea that parties are only indifferent to risk in one limited setting) and Bowers, supra note 5 (challenging the idea that courts are likely to get the right result on average if the language is muddled. If the assumptions are not incontrovertible, then the decision to use those assumptions reflects a choice by the formalists to use those assumptions and exclude others. That deliberate choice then makes the resultant choice of formalism less assuredly correct.
114 Hayek maintained that judicial decision-making is restricted by the spontaneous order in society and legal intervention outside of such order will be ineffective. See 1 FRIEDRICH A. HAYEK, LAW, LEGISLATION AND LIBERTY 118-22 (1973) (“The judge . . . serves, or tries to maintain and improve, a going order which nobody has designed, an order that has formed itself without the knowledge and often against the will of authority, that extends beyond the range
an instrumental defense of formalism.

Whether an unvarying rule embracing formalism absent express delegation should be the preferred default rule depends on a careful analysis of the costs and benefits of the suggested textualist rule, as well as of alternative interpretive rules and informal, non-legal strategies. The cost-benefit analysis must include a consideration of how the various approaches would minimize the costs of contracting for transactors deciding whether to engage in an exchange. But before performing the cost-benefit analysis of textualism, formalism and their alternatives, one must first address both how parties draft contracts and how residual uncertainty may exist in conjunction with express contractual language. Such lack of resolution in contracts must be accounted for in the cost benefit analysis of judicial intervention. Section IV will define the scope of the inquiry, provide a cost benefit analysis of competing interpretive rules and examine current cases and doctrines in Contract law that cannot be explained by textualism. Sections V and VI address those costs and benefits, lay out the textualists’ analytical framework and implicit assumptions on which the analysis is predicated, and identify its limitations and distortions.

IV. Scope of Inquiry: When Does an Interpretation Issue Arise? Examples and Cases

Residual questions will exist even if the parties use express terms, raising the issue of what courts should do in the face of such uncertainty. Textualists and formalists suggest that if the parties use express terms and do not delegate interpretive authority to a court through the use of vague terms such as “good faith” or “reasonableness,” courts should uniformly refuse to go beyond the text. If reformulated, this announced interpretive rule provides that whenever a party uses precise words, and the party’s lawsuit depends on the court going beyond the text, invoking equity, or using an economics-based consequentialist approach to deciding on which interpretive rule should govern the controversy, that party will lose unless it had the foresight to add a clause specifically delegating broad interpretive authority to a court. The court in that situation will be directed to “enforce formal obligations…specified in advance.” Such an approach would

\hspace{1cm} \textit{of deliberate organization on the part of anybody. . . . But even when . . . he creates new rules, he is not a creator of a new order but a servant endeavoring to maintain and improve the functioning of an existing order.”}. \textsuperscript{115} \textit{See infra} Section III.

\textsuperscript{116} Kraus & Scott, \textit{supra} note 23, at 1030 (as supplemented by the judge’s life experience).

\textsuperscript{117} \textit{Id.}
necessarily lead to a lack of resolution on issues not determined by the express language.\footnote{118}

Understanding how and why a contract containing express terms could nonetheless leave residual uncertainty requires that the scope of the interpretation issue be identified and illustrated. We must determine whether interpretation is limited to cases involving how to apply express terms to a particular event, or whether it also includes the question of what should be done when the express terms do not cover an event or condition \textit{in any way}. Whether or not the express terms are intended to address the circumstance at hand, the court must grapple with an issue that is not fully resolved by the express terms, either in terms of the scope of the clause’s coverage or in terms of an actual gap. If the court concludes that the express term is meant to settle a controversy and address the circumstance at issue, a boundary of coverage issue exists unless the coverage of the event or condition is perfectly obvious because of a match with the unquestioned meaning and scope of the term. And once the boundary of the coverage of the clause is at issue, the connection between coverage and non-coverage of an event under the express terms becomes apparent.

Even when an express term addresses the circumstance at issue, the court must also identify \textit{the way in which the express term is meant to settle the question}. The problem of interpretation and the choice of an interpretive rule will not go away unless the court lets the party asking for relief fail whenever the express terms do not settle the application because the term is unambiguous and has unquestioned meaning, or the party expressly, or by using vague language, indicated it wanted the court to decide matters \textit{ex post} or indicated it wanted the court to advert to trade usage or other extrinsic matters.\footnote{119} It simply defies unitary rules.

\footnote{118}{Here is where I part company with Professor Scott, who would, if the court cannot resolve the matter after looking at unclear language and then looking at context evidence and default rules on mistake and excuse, “prefer courts to find the contract insufficiently definite to enforce against either party rather than ask the court to devise a novel solution.” Scott email, supra note 27. In contrast I suggest that courts can devise solutions that are welfare maximizing and preferred by both parties.}

\footnote{119}{A recent example involves the meaning of the term “subsidiary” in a cross-license agreement between Advanced Micro Devices (AMD) and Intel. Per a 2001 agreement between the companies, AMD and its subsidiaries were allowed to use Intel patents to manufacture chips. AMD spun off its manufacturing operations and formed a new company, Globalfoundries. The parties disagreed as to whether Globalfoundries met the subsidiary requirements as set forth in the cross-license agreement and was therefore eligible to use the Intel patent.}
If a contract, for example, obligates a company to pay a fixed fee to a headhunter if the company hires anyone whose name was supplied by the headhunter,\textsuperscript{120} there is a question of how that express term is meant to settle the payment issue. An interpretation question might arise if the headhunter delivered a local phone book to the company and the company, while not using the phone book since it is a useless resource, nevertheless hires an employee whose name appeared in the phone book. The payment clause is not drafted with sufficient particularity to allow a court to simply apply the language to the facts in such a way that no interpretive decision would be required. The inexactitude would permit the headhunter—using textualism—to demand payment under the literal terms. The company could only contest that interpretation if the court were willing to look beyond the contract’s express terms.

The interpretive rule of formalism or textualism does not tell the court which of several interpretations to adopt. Thus, it suffers as a theory because it may fail to devise “a workable solution to complex

\textsuperscript{120}This example was first discussed by Professor Aaron Edlin, Professor of Law, University of California, Berkeley, Comments at the Columbia University Conference on Contracts held April 7-8, 2006. In a recent email exchange with Professor Scott he indicated that he would see no difficulty in admitting contextual evidence, presumably beyond the minimum evidentiary base, in the headhunter case as it involves a clear case of ambiguity. Scott email, \textit{ supra} note 27. However, the difficulty is that some courts could find that the contract has a plain meaning and if one requires ambiguity before allowing extrinsic evidence, the result might be a contract that is too indefinite to be enforceable. The problem is, as Traynor explained, that you do not really know if a text is ambiguous until you look at the context evidence. So, while Professor Scott sees an ambiguity in the headhunter case that would allow context evidence to come in, not every court would reach the same conclusion if a finding of ambiguity had to be made without the extra evidence.
questions. 121 It simply tells the court that if a party’s interpretation depends on matters extrinsic to the contract, the court will refuse to consider such evidence unless the express terms are ambiguous. 122 The plain meaning rule, however, has been conceptualized more broadly to refer to a “linguistic default that restricts the court to” a minimum evidentiary base, thereby limiting evidence even when terms are ambiguous. 123 This broader version of a narrow interpretive rule essentially adopts a non-contextualist default rule that would preclude contextual evidence in a variety of contexts that go beyond honoring the plain meaning of unambiguous terms in an integrated agreement. This broader anti-contextualist default would preclude trade usage evidence to interpret contracts unless the parties specifically agreed to incorporate such terms. 124 It would essentially say to parties that they must opt out of textualist default rules or risk having the court exclude extrinsic evidence unless the court finds the term to be ambiguous on its face, since presumably the textualists/formalists would want to exclude contextual evidence to show that an ambiguity exists. 125

The result will be that a party whose success depends on a broad array of extrinsic evidence will likely lose. Under the textualist and formalist rules, the company in the above scenario would lose if it argued that the court should advert to and reference goals beyond the clause in determining whether the headhunter should be paid for delivering phone books, unless the court found the express terms to be ambiguous on their face. However, a broader interpretive rule would allow the court to reference overall goals of maximizing joint surplus and go beyond the express terms if necessary. Even if there is no ambiguity based on an examination of intrinsic evidence, the consequentialist rule of this Article would permit courts to go beyond the text whenever admitting context would improve welfare, even if that context evidence remains outside of the contract, the context of the business, and the life experience of the judge.

The parties in the phone book scenario could have drafted their contract with a greater degree of specificity but failed to do so. They may have assumed that when the company hired an employee the law would supply a fiduciary duty to constrain the actions of the headhunter, or

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121 See Eskridge & Frickey, supra note 56, at 324 (suggesting deficiencies of grand theories in statutory interpretations and embracing approach that can yield “workable resolution”).
122 Schwartz & Scott, Redux, supra note 27, at 963 (indicating that context evidence may be admissible where term ambiguous).
123 Schwartz & Scott, Limits, supra note 30, at 585.
124 Id. at 586.
125 Goetz & Scott, supra note 35, at 273.
would supply a standard of reasonableness by which to measure the
headhunter’s performance. Such an implied standard would permit the
court to determine that the headhunter’s performance is defective even if
it meets the literal meaning of the express terms.

Denying a court the opportunity to make such a determination
absent an express opt-in would add to the cost for all future transactors
who might be forced to undertake additional drafting costs to prevent
courts from insisting on literal interpretation of their contracts. If most
parties would assume that an express opt-in would not be needed to rule
out an unreasonable interpretation\textsuperscript{126}—that permitted the headhunter to
be paid for delivering the phone books—then a decision for the
headhunter would deter future transactors from contracting. Future
transactors might be worried that parties would have to draft exceedingly
carefully to leave no residual uncertainty to avoid unreasonable
interpretations of language by courts.\textsuperscript{127} Similarly, if a court could only
admit context evidence in the form of the contract text, information about
the basic business of the parties, and the life experience of the judge, a
court might ignore its mission to interpret contracts so as to deter
opportunistic behavior as a means of maximizing wealth by lessening
transaction costs.

The problem of express terms leaving residual uncertainty can be
seen more broadly. In many cases, if a court adhered to formalism, it
would potentially promote opportunism. Even under Scott’s analysis in
which courts can refer to context to interpret ambiguous terms, it is not
clear that a judge could consider anything beyond the restricted sphere of
evidence consisting of the contract itself, the judge’s life experience, and
a dictionary. External evidence supplied from course of dealing, trade
usage, and other sources whose consideration could clarify the admitted
ambiguities and reduce interpretive risk is still excluded. A recognition
that formalism would chill future transactions causes courts to look

\textsuperscript{126} An analogous doctrine in statutory interpretation permits courts to rule out
interpretations that would promote “unreasonable consequences.” Eskridge,
\textit{supra} note 67, at 1483. Similarly, if a court could only admit context evidence in
the form of the contract text, information about the basic business of the parties,
and the life experience of the judge, a court might think that its central mission
of contract interpretation would not extend to deterring opportunistic behavior as
a means of maximizing wealth by lessening transaction costs.

\textsuperscript{127} A more difficult question of interpretation would arise if the headhunter
performed a valuable service, such as assembling the resumes of qualified
people and transmitting those resumes to the employer. This might be equivalent
to the Faculty Appointments Register for law school teaching jobs. Pre-
screening the resumes would provide a more valuable service, but one that
would entitle the headhunter to a larger fee. Lee Fennell contributed this insight.
beyond literalism to decide what the terms of a license agreement mean. In *Beanstalk Group, Inc. v. AM Gen. Corp.*,128 Beanstalk contracted with AM General to negotiate license agreements for AM General’s “HUMMER” trademark. The contract provided that Beanstalk was AM General’s “sole and exclusive nonemployee representative” and was entitled to thirty-five percent of the “gross receipts . . . received on Owner’s [AM General’s] behalf under any License Agreements” for the Hummer trademark.129 During the period governed by the representation agreement, AM General and General Motors entered into a joint-venture agreement.130 Under the agreement, GM would design and engineer a new Hummer vehicle, loan money to AM General to build the new Hummer, and obtain an option to buy forty percent of AM General and the Hummer trademark. Beanstalk argued that the agreement between AM General and GM, which provided GM with the exclusive right to merchandise the Hummer trademark, was a license agreement. Therefore, Beanstalk claimed it was entitled to thirty-five percent of the value of the Hummer trademark.131

Although the court announced that the contract should be enforced “in accordance with the ordinary meaning of the language used and without recourse to evidence, beyond the contract itself,” it ultimately reached its decision by interpreting the contract in the manner that best promoted future business exchanges and discouraged opportunistic behavior. The court pointed out that Beanstalk was in the business of merchandising trademarks; thus, it could use license the Hummer brand to a toy company seeking to make toy Hummers. The agreement between AM General and GM, however, was not this sort of agreement. Instead, it was a joint-venture, where AM General “essentially transferred the Hummer business” to GM. Since “Beanstalk is not a business broker,”132 the court noted that it would make little sense to pay an agent, such as Beanstalk, for work that AM General did itself.

In reaching the result that makes the most economic sense, the court spelled out its logic:

In the case of a commercial contract, one must have a general acquaintance with commercial practices. This doesn’t mean that judges should have an M.B.A. or have practiced corporate or commercial law, but merely that

129 Id. at 858 (internal quotation marks omitted).
130 Id. at 859.
131 Id.
132 Id. at 861.
they be alert citizens of a market-oriented society so that they can recognize absurdity in a business context. A blinkered literalism, a closing of one’s eyes to the obvious, can produce nonsensical results as this case illustrates.\footnote{Id. at 860.}

The court did not interpret the contract literally; in refusing to do so, the court reached the best result to promote future transactions between AM General and other companies seeking to represent their brands—a consequentialist interpretation. A literal interpretation of the licensing agreement would have required a party selling its business to give up a huge percentage of its overall assets to a licensee who had nothing to do with brokering the sale or building the assets of the company. That windfall might provide a future disincentive for parties to enter licensing agreements or to sell assets. The prospect of an unearned windfall would act as a drag on all gains from trade across many transactions. In reaching the opposite result, the court discouraged opportunistic behavior and an unearned windfall. This willingness to depart from a literal-minded interpretation helps to increase the surplus by reducing the prospect of future litigation. Parties hoping to gain windfalls from literalistic interpretation of contract will be discouraged from bringing lawsuits in the future.

A court employing a more strictly formalistic interpretation may not have reached such an obviously equitable solution. In adhering only to the terms of the contract, and not referring to external business knowledge, the essential issue—that Beanstalk contributed nothing to the deal between AM General and GM—would be lost. Such “blinkered literalism”\footnote{Id.} was recognized by the \textit{Beanstalk} court as providing only flawed and “nonsensical” interpretation. Though a Scott formalist analysis may allow the judge’s life experience in cases of ambiguity, the court itself recognized that a judge may not (and should not necessarily) have an MBA or business knowledge. Thus, the pool of evidence a court may draw from that will produce an equitable decision is variable, changing significantly with the appointed judge. Given the interest of the formalists for stable, bright-line interpretation standards, the potential for such disparate results betrays the underlying purpose for such narrow rules for admission of evidence.

Literal interpretations of certain contracts can also give opportunistic incentives that hinder fair and efficient transactions. In \textit{Deloro Smelting and Refining Company v. The United States}, the parties

\begin{footnotesize}
\footnote{Id. at 860.}
\footnote{Id.}
\end{footnotesize}
disagreed on how price term for a supply contract was to operate.\textsuperscript{135} The United States contracted with a Canadian smelting company, Deloro, to purchase cobalt metal in 1950. If Deloro delivered the cobalt after a certain date, an escalation clause enabled the United States to pay Deloro a price based on a fixed percentage of the domestic U.S. market price for cobalt, found in the Engineering and Mining journal “as of the date of delivery of the cobalt metal.”\textsuperscript{136} Deloro failed to deliver the cobalt according to the contract’s delivery schedule, but the United States did not terminate the contract. Once the escalation clause became operative, the accounting and financial personnel working for the United States paid Deloro based on the price quotation operative on the actual date of delivery, not the scheduled date. In 1954, the United States insisted it had been overpaying Deloro because the price of cobalt had risen; thus, payments based on a later date, the actual delivery, resulted in a higher price. The United States began paying Deloro based on the scheduled date of delivery and subtracted sums equal to its prior over-payment. After this change, Deloro refused to continue its contractual performance until the United States paid it the amounts taken out of its payments and signed a binding agreement to compute future prices based on the actual date of delivery.

The United States Court of Claims addressed an interpretation issue: whether the phrase “as of (or at) the date of delivery of the cobalt metal” in the price escalation clause referred to the actual date of delivery or the scheduled date of delivery.\textsuperscript{137} The court’s analysis focused on a reading of the contract that would have been “understood by reasonable men standing in the parties’ shoes.”\textsuperscript{138} First, the court noted that prompt delivery of cobalt was expected because the U.S. government’s statutory authority to receive cobalt had an expiration date.\textsuperscript{139} The parties must have assumed that Deloro would be able to make timely delivery. The court also pointed out that parties must have anticipated the rise in cobalt prices because they included an escalation price adjustment clause.\textsuperscript{140} The combination of these two factors led the court to reason that the “price-change provisions were plainly meant to be intertwined with the due dates for delivery—expected by both sides to be the actual dates of delivery.”\textsuperscript{141} Second, the court pointed out that if Deloro’s interpretation were accepted, then “there would be a malevolent

\textsuperscript{135} Deloro Smelting and Ref. Co. v. United States, 317 F.2d 382 (Ct. Cl. 1963).
\textsuperscript{136} Id. at 384 (internal quotation marks omitted).
\textsuperscript{137} Id. at 385.
\textsuperscript{138} Id. at 386.
\textsuperscript{139} Id.
\textsuperscript{140} Id. The court attributed this price-rise anticipation to the parties’ awareness of Korean hostilities.
\textsuperscript{141} Id. at 386-87.
incentive . . . for the contractor deliberately to postpone performance in order to increase its recovery." 142 From a business standpoint, it would make little sense for the United States to pay higher prices for shipments of cobalt that were late. Therefore, the court construed the contract with “business sense, as [it] would be understood by intelligent men of affairs” to determine that date of delivery meant the scheduled date of delivery. 143

This case is an example of a precise term which turns out not to be so precise. If Scott were to admit this term is ambiguous, his current theory does not lay out a plan for resolving the ambiguity to minimize transaction costs. Without the security that a seemingly unambiguous term will be interpreted equitably or reasonably in light of the parties’ ultimate contractual intent, transacting may chill, or become prohibitively complicated and expensive, due to concern that a contract cannot be drafted to protect party interests. If a party cannot anticipate that a term will become ambiguous, it cannot draft a safe contract. Under a formalist interpretation, that party’s intent and their contractual ends would not be a factor in interpreting (plain) meaning. However, recourse to a court that takes into account party and contractual intent will promote transacting against the backdrop of an equitable judicial environment. Ultimately, when courts interpret contracts with a sensible, business-oriented reading, parties can be more confident that they will not be victims of opportunistic behavior.

V. Intervention Choice and the Reduction of Costs for Parties: A Framework

Before using a cost-benefit analysis to assess the best interpretive strategy for courts to take in cases in which the parties have adopted express terms and yet failed to delegate broad interpretive authority to a court, one must model a framework for how parties bargain, why they enter into exchanges other than spot transactions, and how a particular interpretive rule announced in advance would affect the achievement of the parties’ goals.

Courts must defend their intervention choice in terms of cost because parties themselves want to minimize the costs of transacting. 144

142 Id.
143 Id. (internal quotation marks omitted) (quoting The Kronprinzessin Cecilie, 244 U.S. 12, 24 (1917)). *Actual case name is N. German Lloyd v. Guar. Trust Co., 244 U.S. 12, 24 (1917).
144 WILLIAMSON, supra note 45, at 1 (making the related point that “economizing [on transaction costs] is the core problem of economic organization”).
Parties who exchange through other means than spot transactions do so to minimize the costs of exchange. They want to reduce the risk of transacting as a way of minimizing costs, including the interpretive risk from leaving a contract with residual uncertainty given a particular interpretation rule. These costs and risks are viewed by the parties to any transaction ex ante and probabilistically.

The parties may adopt an express term that is meant to settle a controversy in some way. But the parties may fail draft with the level of particularity and detail needed to resolve all possible questions, given uncertainty and the unforeseeability of the future. Each party has to decide how many resources to put into bargaining and drafting. Each will invest when the costs of doing so are outweighed by the benefits. The costs include the haggling time necessary to develop a mutual understanding, investment in information, and the thinking cost of anticipating future states of the world and the proclivities of the other party for opportunistic behavior. The benefits of investing in bargaining and drafting are to reduce opportunism and similar actions that would reduce gains from trade. Because parties draft contracts ex ante, and the contract will be performed at a later point in time so the question may arise of how to interpret express terms given later developments. Contract interpretation is necessary and important because parties cannot devote infinite resources to articulating their bargain. If drafting and, even more importantly, thinking costs were free, interpretive problems would never arise. Thus, the use of express terms is beset by the same cost of drafting issues as where parties decide to use no express terms or leave gaps in contracts. For that reason, this Article will treat these two issues together and use examples from both interpretive and gap filling disputes.

The interpretive rule analysis suggested here generally asks whether the “costs of specifying” are either (1) more than the costs of risking non-specification or (2) more than the surplus achievable by the exchange. The first prong of the cost analysis is important although sometimes overlooked. One would not want to continue to draft if the drafting costs outweigh the risk of non-specification. And, under the second prong, one would not undertake drafting costs if such costs outweigh any possible gains from trade. Thus, parties may compare the residual cost of an interpretation risk against the cost of drafting

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145 The economist denominates such a world that consists exclusively of spot transfers as a market.
146 See WILLIAMSON, supra note 45, at 46.
147 In evaluating the cost of interpretive risk to the parties ex ante in any contract setting, one must factor in the interpretive rule that a court would use and would announce in the future to interpret that contract. One would expect courts to
further. The interpretive risks include: (1) inaccuracies in interpretation which occur when courts depart from a meaning of express terms that both parties agreed on;\(^\text{148}\) (2) the risk that courts will invest the contract with a meaning that fails to maximize gains and minimize costs;\(^\text{149}\) and (3) the risk that courts will interpret the contract to facilitate opportunism.\(^\text{150}\)

In evaluating the cost of interpretive risk to the parties \textit{ex ante} in any contract setting, one must factor in the interpretive rule that a court would use and would announce in the future to interpret that contract. One would expect courts to attempt to minimize \textit{ex ante} interpretation risks to classes of transactors represented by each party to a contract and thereby decrease the overall costs of contracting, at least in cases where the court can intervene at a lower cost than whatever other mechanisms exist to lower the interpretive risk (including reputational and informal sanctioning mechanisms).\(^\text{151}\) Such a rule would presumably affect the resources parties devote to drafting.

When parties have not invested enough resources to eliminate all interpretive risks, the question is how should the court decide whether

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\(^\text{148}\) The difficulty of proving that the parties jointly agreed on a particular meaning to be attached to given words is well known in both contractual and statutory interpretation contexts. See \textit{Cohrbin on Contracts} § 24.2 (detailing difficulty that “tension between the parties’ respective interests ‘poses in contract interpretation’); see also Frickey & Eskridge, \textit{supra} note 56, at 325-32 (discussing problems of discerning legislative intent including indeterminacy and lack of access to actual intent in statutory words).

\(^\text{149}\) The risk could materialize in several ways. A court could adhere to a literal interpretation that it increases the costs of contracting. Or alternatively, a court could add to interpretive risk by “incorrectly refus[ing] to enforce ‘express terms’ in favor of some implied term or contextualist interpretation.” Cohen, \textit{supra} note 17, at 8.


\(^\text{151}\) For a discussion of reputational sanctioning mechanisms, see Kostritsky, \textit{supra} note 150, at 477-80.
and when to engage in ex post interpretation. The benefits to be achieved from bargains could be obtained through more specific and complete drafting, but courts should recognize that these benefits could alternatively be achieved by trusting in one’s ability to work out any interpretive problems with the counterparty or by trusting a neutral to interpret the contract in a way that maximizes gains from trade. The contextualists and formalists resolve that question differently, but it is important to recognize that each approach is built on differing assumptions about the parties’ expectations and drafting choices. It may be that ultimately the choice of an interpretive method depends on empirical data.

Courts must decide what significance to attribute to the use of a precise term in a contract and ascertain whether the use of a precise term indicates a choice by the parties about the preferred interpretive method to be used. The use of a precise term, as opposed to a broad and open ended term, may exist for a variety of reasons that do not signal a desire to foreclose a court from any later interpretive role. First, a precise term may be employed by parties who thought that the term needed no further elaboration because it was clear. Thus, the reason that they did not draft further or expressly invoke the authority of the court to engage is ex post interpretation is that they did not foresee the need for such interpretation. Under this assumption, the use of a precise term cannot be interpreted as a disavowal of interpretive authority by the court.

Second, the use of a precise term may reflect a failure to anticipate how a future event might affect the term in a way which might benefit from or require ex post interpretation. So, for example, if the

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152 The modern formalist/textualist attributes great significance to the use of a precise term. The background to the debate regarding the importance of a precise term is traceable to a distinction drawn between observable and verifiable matters. The classic instance is the problem of a shirking worker whose behavior, while observable by an employer, may not be verifiable to a court. Alan Schwartz analyzed this distinction when he explained why parties might settle on a precise term rather than an open-ended one. Parties might, for example, choose a contract in which the manufacturer’s price for an item was set at a certain fixed price per unit in order to avoid “the strategic-behavior risk” that accompanied a contract in which the price fluctuated with demand since that matter might not be observable to the seller and certainly not verifiable to a court. See Alan Schwartz, Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies, 21 J. LEGAL STUD. 271 (1992). This Article differs from these types of analyses in surmising that the use of a precise term may be due to bounded rationality constraints; parties simply settle on a precise term without being aware of the need to draft further or they settle on such a term to save on transaction costs on the assumption that a court will be able to interpret the term to maximize gains from trade.
parties “specify that material A should be used in construction but that they would really prefer substituting B if an unusual problem arises with A,”¹⁵³ the use of the precise term should not necessarily be read as a rejection of *ex post* interpretation but rather as a drafting choice that arose because of the unforeseeability of the future.

Courts also have to deal with contracts lacking a clause phrased in broad or open ended terms to expressly allow *ex post* interpretation. If a contract fails to use terms like “reasonable” or “good faith,” what implications can and should a court draw from that failure to delegate *ex post* interpretive authority? Whether that assumption makes sense requires further analysis. Essentially, this assumption requires that if parties want *ex post* interpretation, they must draft for and anticipate the need for such interpretation *ex ante*. The textualists and formalists in essence are forcing parties to make choices about *ex post* interpretation that may not be an appropriate subject of bargaining. Thus, if parties are bargaining over the sale of a tractor, for example, they also have to anticipate the need for *ex post* interpretation or they will be subjected to a narrow approach to interpretation. If they fail to anticipate the need for opting into *ex post* interpretation by the court, they will be foreclosed from accessing courts’ broad interpretive powers.

That assumption seems counterintuitive, especially when one considers the enormous drafting costs for contracts and the parties’ reasonable assumption that courts will intervene with reasonable terms using a variety of broadly used interpretive techniques. One would wonder why parties would want courts to abandon all interpretive techniques that are routinely used in case law and whether it would be safe to assume that parties had intended to foreclose such techniques based simply on the failure to adopt a specific phraseology such as “good faith” or “reasonable.” Parties would more likely explicitly exclude them rather than leaving it to a court to infer that the absence of an open ended phrase or vague term meant that the parties intended such exclusion. Therefore, courts should not necessarily assume that the failure to explicitly address a particular matter, even if that matter is consciously adverted to beforehand, means that the parties intended to bar consideration of the parties’ goals in interpreting the terms. Because the absence of an open-ended term itself requires interpretation, the court is intervening but doing so based on a questionable assumption about party choice.

Another significant assumption underlying the textualist theory is that if the parties fail to expressly invoke broad interpretive authority,

¹⁵³ Shavell, *supra* note 24, at 289.
they intend to rely exclusively on informal mechanisms of enforcement to deal with the residual uncertainty problem in contracts.\(^{154}\) There is an assumption that if parties do not use vague terms, they have removed discretion from the court and, simply by choosing a precise term, have subscribed exclusively to informal enforcement mechanisms to deal with the unexpected events.\(^{155}\) According to the textualists, if a matter is not addressed with a sufficient degree of precision in the contract, then the parties have knowingly chosen to exclude it from legal enforcement.\(^{156}\) Yet, it is far from clear that when the parties stop short in drafting, they are deliberately opting out of all legal enforcement for matters not explicitly addressed or matters requiring interpretation beyond the explicit terms.

A number of problematic assumptions undermine this argument in favor of exclusive and deliberate reliance on informal mechanisms. These include the idea that in choosing terms, parties mentally choose to partition between informal and legally enforceable parts of the overall agreement, that all firms are risk neutral in all of their decisionmaking, that parties would opt for exclusive reliance on informal mechanisms regardless of how robust those mechanisms were in a particular setting, unquestioning acceptance of the crowding out phenomenon, the equating of a merger clause with a separate decision to rule out all unconventional uses of doctrine and the assumption that accuracy rather than minimization of interpretive risk lies at the heart of the interpretive task. The first flaw is that the textualist/formalist argument depends on a deliberate and rational partitioning between legally enforceable and legally unenforceable aspects of the contract. The idea is that reliance on private strategies to resolve matters not clearly and unambiguously intended to be covered by the express language reduces costs more than the alternative of judicial enforcement. There is an assumption that if parties do not use vague terms, they have remo\(^{157}\) Often parties believe that the precise term covers every possible circumstance and cannot envision any need for a court to intervene. The parties do not invoke the authority of a court because they assume it will not be needed.

But if most parties are generally happy with the principal terms of their deal, such as what is being bought or sold, price or value return, timing, duration, etc., and a party is satisfied with the big picture (the so-called “business points”) and reluctant to expend time and resources to niggle smaller items (“lawyer points”), then the parties may well fail to


\(^{155}\) See id.

\(^{156}\) Kraus & Scott, *supra* note 23, at 1048.
opt into a broad interpretive rule. The choice not to expressly opt into a broad rule could be based on the view that (1) reputational and informal mechanisms will be the sole means to solve any later arising interpretive dispute or (2) on the contrary assumption that a neutral party, such as a court, will be available to interpret the contract in such a way as to maximize the surplus. In a way, investments in bargaining and drafting, trust in a neutral court, and re-bargaining in the shadow of the law are all means of achieving the benefits of bargains.

The assumption that parties intend to rely exclusively on informal mechanisms and to foreclose judicial *ex post* interpretation unless that term was expressly invoked by the parties would seem to rest on a certain underlying assumption about the role of the judiciary in contract litigation. A common assumption would be that the court would have broad authority to interpret contracts and to decide on the best interpretive rule or any other rule in Contracts without an express delegation. Thus, the textualist assumption seems contrary to what most parties would assume. If parties fail to invoke the court’s authority to engage in *ex post* interpretation of the contract, then the court should stay its hand and do no harm and refrain from expansive interpretation of contracts. Under the guise of protecting party choice built on the empirically questionable assumption that every party who wants expansive interpretation will include the appropriate language and those who do not do so wish to reject such interpretation, courts would be disabled from engaging in the kind of interpretation of contracts that they have routinely engaged in.

Another problematic assumption is that the level and degree of informal enforcement is “pervasive and robust.” In many instances the conditions for such enforcement are not present, as where there is no effective means for transmitting information about possible shirking behavior by contracting parties, the group is too large or lacks homogeneity, or there is no agreement on what behavior would warrant reputational sanctions. In such instances, it may be unwise to assume that the parties intended to rely exclusively on informal enforcement, even if they stopped short of drafting with a sufficient level of precision to resolve all issues.

The new textualist argument also seems to be based on a particular (though largely unacknowledged) behavioral assumption about

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157 Of course, the parties could bargain for a court to rely exclusively on a literal interpretation of the contract. If they did so, the court would be likely to respect such a term, although as Professor Charny has pointed out, that clause itself would require interpretation. Cite.

158 Stephenson, *supra* note 99. –cannot find “pervasive and robust in this source
dispute resolution. The argument suggests that if a court lends legal enforcement to a matter that does not either demand judicial resolution via an express delegation or does not clearly resolve the matter in question through a relevant contractual clause, then that enforcement will have negative welfare effects. It will “crowd out informal enforcement.”\textsuperscript{159} While there is some experimental data supporting this crowding out thesis,\textsuperscript{160} I remain skeptical for two reasons. First, other experimental data suggests that there can be complementarities between legal and non-legal enforcement. Second, once the high cost of litigation is accounted for, a logical objection to the crowding out phenomenon appears.\textsuperscript{161} Litigation is so expensive that it is a very rare case when either party would prefer litigation over informal sanctions. In the rare case where the parties resort to litigation, it is usually because there are large dollar amounts at stake and those dollars have prompted one party to act in an opportunistic fashion. This is precisely the type of case where litigation could helpfully supplement informal sanctions, which are likely to be ineffective when the benefits of opportunism outweigh the reputational costs.\textsuperscript{162}

The arguments for a textualist or formalist interpretive approach

\textsuperscript{159} Kraus & Scott, supra note 23, at 1058. Professors Scott, Gilson, and Sabel argue that “sophisticated parties know better than courts how best to mix” informal and formal enforcement. Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, \textit{Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine}, 110 COLUM. L. REV. 1377 (2010). An interesting new article makes the case that parties themselves are engaged in allocating enforcement between informal and formal enforcement when they arrange their affairs in pharmaceutical contracts between the investor and pharma. In those contracts, the parties agree to share information, and they would be liable for the breach of the agreements. But as the parties learn more about the counterparty and start to work together on a project or a new drug, the formal enforcement is displaced by informal enforcement. As the entities become more entwined, the costs of switching increase, which in itself acts as a kind of informal enforcement mechanism. Scott, Gilson, and Sabel have uncovered a real life example in which parties have allocated enforcement strategies between informal and formal sanctions.


\textsuperscript{161} William C. Whitford also independently contributed this insight.

rely on a particular cost benefit analysis as well as particular assumptions about how parties weigh drafting costs against ex post enforcement costs. Textualists argue that if parties draft express terms, they have invested large front-end costs to avoid ex post enforcement costs. They assume that if a term is important to the parties, that parties themselves will devise an answer in the contract but that it will sometimes be costly for a court to figure out what the right answer is (the accuracy problem). They recognize that if courts depart from the text and evaluate more evidence, courts would have a greater probability of reaching the accurate result. However, because parties are risk neutral and only care about a court getting the correct answer on average, most parties would prefer that courts adopt a textualist approach to interpretation as the extra enforcement costs are not worth the gains in accuracy.

Several problems undermine this version of a cost-benefit analysis. The textualist argument overlooks a fundamental problem: there may be no correct answer. Failing to recognize that leads to a misspecification of the problem. If each party admits that it did not know the other party’s meaning, then the “accuracy” at the center of a contract is lack of resolution. To resolve that lack of resolution, the court should frame an interpretive rule that reduces the interpretive risk for all classes of transactors as a way of achieving the parties’ presumed goal of lowering transaction costs and maximizing surplus. Thus, the tradeoff is not necessarily between weighing the greater accuracy that could be achieved by taking in more evidence and the sufficient degree of accuracy that can be achieved by looking only at the contract’s terms; it may also include a lowering of interpretive risk from a court’s interpretation of the contract.

Different assumptions may call for different conclusions on whether textualism or expansive interpretation is more cost effective. First, even when parties employ express terms, there may be no accurate interpretation if the parties’ own strategy is to leave some matters to less rather than more elaborate specification. When matters remain unresolved for cost reasons, the court should reduce the interpretive risk stemming from that residual uncertainty because the parties will deduct the interpretive risk from their gains from exchange and will stop drafting when the interpretive risk becomes less than the costs of drafting

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163 Id. at 575.
164 Id. at 550 n.16.
165 Id. at 577.
166 See Cohen, supra note 17, at 5 (“Economists and courts start from the presumption that courts should follow the intention of the parties. To admit incompleteness, however, is to admit that the intention of the parties is uncertain, or at least disputed.”).
further.

Second, parties care about more than achieving a mean or average payoff; they care about courts minimizing interpretive risk. Courts should not focus on the costs and benefits of achieving greater “accuracy” in interpretation. Since the parties themselves stopped drafting in a way that left the central problem unresolved, courts cannot realistically access an accurate answer. Nor should courts assume that, because there is a normally distributed probability of outcomes in interpretation, the purchaser of a project covered by a contract and subject to interpretive risk would be indifferent to variance or be risk neutral. Because of the decreasing marginal utility of wealth, the purchaser of a project with a payoff will care about variance in interpretation and will view it as a cost. The purchaser will expend resources to reduce variance and minimize interpretive risks. In interpreting contracts, courts should focus on whether the interpretation adopted will increase or decrease risks (and costs) over time to different classes of transactors. Parties want to increase the payoff from entering transactions by reducing all costs, including the cost of interpretive risk affecting contracts. Parties want courts to use an interpretive rule that maximizes payoffs by reducing the drag of interpretive risk.

The biggest problem with textualism’s cost-benefit analysis is the model of the tradeoff made by parties in deciding what kind of interpretive rule they would prefer. One key piece of the argument is that commercial parties are risk neutral and they only care about a court reaching the correct answer on average. For that reason textualists believe that a firm “is unwilling to incur additional costs in order to increase the accuracy of any particular finding.” The tradeoff is between admitting more evidence to increase accuracy and the costs of doing so, which include greater uncertainty from the admissibility of such evidence. Firms are willing to give up some degree of accuracy (some wrong judicial determinations of terms) to save costs since the

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167 See Bowers, supra note x (there are two Bowers articles cited); see also Bayern, supra note 5, at 946.
168 Add cite.
169 See infra.
170 See Schwartz & Scott, Limits, supra note 30, at 575 (“When analyzing the parties' preferences regarding interpretive styles, we begin at the litigation stage and make three assumptions: that (1) a court that relies solely on the minimum evidentiary base \(B_{\text{min}}\) will find the correct answer \(i^*\) with positive probability, (2) that the likelihood that a court will find \(i^*\) sometimes can be increased if the court considers evidence in categories additional to \(B_{\text{min}}\), and (3) that courts are unbiased.”)
171 Schwartz & Scott, Redux, supra note 27, at 931.
greater accuracy is not worth the costs of achieving it.

Two problems undermine this trade off analysis. First, firms are not risk neutral except in one limited sense. Risk neutrality has two meanings. In one of its two distinct meanings, risk neutral parties comprise those who “in arriving at the present value of a future income stream of possible values, do not discount the ex ante expected value in light of their uncertainty, risk.”¹⁷² Most actors, including commercial firms, are not risk neutral in this sense when evaluating projects that they might initially invest in. The sense in which firms are thought to be risk neutral is “with reference to selecting from among risky projects after valuation of a future income stream of risky values has been correctly established in light of risk.”¹⁷³ “At this second stage, if managers can costlessly shift from one risky project to another, then as amongst those differing and risky projects, firms are risk neutral.”¹⁷⁴ This is the sense in which economists mean to refer to firms being risk neutral.¹⁷⁵

Second, if firms are not risk neutral, then they would indeed care about achieving greater accuracy in interpretation.¹⁷⁶ So, to the extent that the assumption of risk neutrality does not hold, the conclusion that parties care only about average accuracy is less convincing. But, for our purposes, it does not matter whether one accepts that firms are or are not risk neutral. Regardless of one’s conclusion on their degree of risk neutrality, the argument that the parties would only care about reaching average accuracy in an average number of cases overlooks a fundamental mistaken assumption. If there is unresolution, then courts deciding cases must necessarily go beyond the text to a consequentialist framework to reach any solution that the parties would prefer. Otherwise, there would be no chance that the courts would reach even average accuracy in interpretation and parties would disprefer interpretative approaches that resulted in below average accuracy or that facilitated opportunism or otherwise failed to maximize contractual surplus.

Thus, even if parties were deemed to be risk neutral, and indifferent to variance, they would still want courts to adopt an approach to interpretation that increased the payoff and minimized the cost of transactions. Just as contractors attempt to structure transactions to lessen

¹⁷² E-mail from Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law to author (Dec. 15, 2006, 11:42 EST) (on file with author).
¹⁷³ Id.
¹⁷⁴ Id.
¹⁷⁵ Cite
¹⁷⁶ See Cohen, supra note 17, at 15 (“Contracting parties do not demand enforceable coin flips to resolve their disputes.”).
moral hazard or opportunism, so too would parties subscribe to courts adopting a rule to lower interpretive risk unless the offsetting costs of judicial errors were greater than the expected increase in surplus.

The textualist/formalists extend this analysis to cases involving an integrated agreement or the use of a merger clause, arguing that courts should not use equity in these cases because an integrated agreement or the use of a merger clause signals the parties’ desire to have only formal doctrines govern.\textsuperscript{177} This analysis puts too much emphasis on the parties’ choice to include a merger clause. Even if parties, for example, have chosen to integrate their agreement, they may not have necessarily meant to exclude courts “applying formal doctrines in a nonconventional fashion.”\textsuperscript{178} Nor does the presence of a merger clause by itself resolve how the parties wish courts to deal with an oral condition in a written contract with a merger clause. The textualists think that the merger clause means that evidence of an oral condition must be excluded (contrary to a result in a famous case). Yet, the merger clause is not self-enforcing. It does not automatically exclude oral conditions in a contract, particularly where the result of excluding evidence of the oral condition might result in one party opportunistically exercising an option. Thus, contrary to what Kraus and Scott argue, the merger clause does not resolve all the potential issues arising in an integrated contract. In order to determine if there is a contradiction (and in what sense), the court must first actually interpret the term.\textsuperscript{179} This belies the textualists’ belief that the merger clause means all extrinsic evidence will be excluded. Further, a court, in deciding as a matter of first impression whether an oral condition can come in despite a merger clause, must grapple with whether exclusion (which is not part of the actual parol evidence rule itself) would be a result preferred by both parties.

The final strand of textualism is the view that unless parties opt into the use of equity, courts should not consult such principles in deciding ordinary contract disputes. Yet, there is nothing in the parties’ contract that forecloses such resort to equity.

VI. Crafting an Intervention Framework

Once a lack of resolution in contracting is accounted for, the question becomes whether the parties would prefer courts to intervene and resolve the lack of resolution with an announced interpretive rule. If that rule could be crafted to enhance the willingness of parties to

\textsuperscript{177} Kraus & Scott, supra note 23, at 1046.
\textsuperscript{178} Id.
\textsuperscript{179} CORBIN ON CONTRACTS ONE VOLUME EDITION SECTIONS 573-96 (p.536)(1985)
exchange, parties would prefer court intervention. Courts should interpret contracts in order to maximize the gains from trade, minimize transaction costs, and control hazards of contracting, including opportunism. Doing so mimics the legitimate goals of the parties in making the bargain and therefore reflects the intention of the parties, which courts should honor. In order to do that, courts must determine the obligations of the parties under the contract as written, given the context in which the deal was made and the intentions of the parties that reflect the goal of maximizing gains from trade, minimizing transaction costs, and controlling hazards. Even if one assumes that the parties did not resolve a matter, the court still has to interpret the language that supposedly encapsulated that meaning. Interpretive rules are needed to guide the process of identifying the agreed upon meaning. Thus, whether one assumes that the parties reached consensus on an agreed on meaning or failed to do so, leaving residual uncertainty, a court must decide what to do.

Parties bargain over their obligations. If parties could perfectly craft a complete contract, it might be self-enforcing, and courts would never have to interpret the contract because there would never be a breach or a need for interpretation. But the parties have bounded rationality, and may not be able to foresee a future dispute causing the need for judicial intervention or reputational sanction. They may not even see the need for judicial intervention to deal with behavioral uncertainty, which includes the proclivities for opportunistic behavior by a counterparty. It may not be efficient to invest in addressing future contingencies or future opportunism, the exact nature of which may not be anticipated, especially in light of the other ways of addressing the contingencies: such as relying on trust or judicial intervention. Bargaining requires the parties to determine how much effort to put into forecasting relevant circumstances that might change and the terms of their performance under those circumstances. Parties can rationally decide not to invest in investigating changed circumstances or to deal with changed circumstances by relying on trust (new good faith negotiations in the face of the law) or judicial intervention. Parties can also deal with the possibility of changed circumstances by setting a goal they agree should be achieved under any set of circumstances.

Because the courts’ function is to achieve the legitimate goals of

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180 Thus, while adverting to overall goals of maximizing surplus and minimizing transaction costs, courts should on the other hand not use specific contractual goals that were not enacted into the contract precisely because were avoiding use of a contract term that might remain unverifiable to courts.
the parties (wealth maximization, minimize transactions costs, and reducing opportunism), it must put itself in the role of the parties and interpret the contract in light of what they must have intended in order to reach those goals. If one of the parties intended some other goal, that intent is itself a form of self-dealing and opportunism that need not be recognized by the court.

One thing parties negotiate over is the interpretive methodologies for the bargain; so they negotiate over how many contingencies to cover with explicit terms and how to deal with contingencies that it would be inefficient to address. But if the parties do not select an interpretive methodology, courts should again start with a default interpretation that maximizes the gains from trade, minimizes transaction costs, and control hazards of contracting. It rejects the view that unless the parties expressly delegate interpretive authority to a court, the court should decline to intervene with a broad interpretation. A default rule that says that language will be interpreted narrowly or literally unless the parties expressly provide for a different scope and expressly delegate authority to the courts would raise transaction costs in a way that will preclude many bargains.

Realistic assumptions about how parties bargain should help courts select an appropriate rule. Thus, courts should not decline to exercise interpretive authority merely because the parties have used a precise term or failed to grant broad interpretive authority. There are many reasons why they would use a precise term without intending to foreclose later judicial intervention by a court. Parties may choose a precise term because the uncertainty of the future makes it difficult to build in the mechanisms to vary the precise term. They may also settle on a precise term thinking that it completely resolves all future issues. Parties normally negotiate in reliance on trust and renegotiation in the shadow of the law, and that means that judicial intervention—the shadow of the law—is the default rule. There are so many reasons why parties might use precise terms and fail to delegate based on transaction costs and limits on rationality\footnote{WILLIAMSON, supra note x, at 45 (distinguishing bounded rationality from nonrationality).} that the optimal approach should proceed by considering how likely is it that parties would have wanted to limit judicial interventions to restrain opportunism, given the context bargaining process and the costs of drafting to eliminate all residual uncertainty. And, if only one of the parties would have wanted to forbid judicial intervention to police opportunistic behavior, how likely is it that such party compensated the other party for giving up that means?
Thus, in crafting an intervention choice for courts, this Article suggests that the use of a precise term by itself should not foreclose courts from exercising discretion in the interpretation of contract. Most parties would assume that courts are not indifferent to the goals of parties in contracting and that parties, at least behind a Rawlsian veil of ignorance, would want judges to make decisions that realize those joint goals. Thus, the parties may assume that there is no need to adopt a specific phrase inviting courts to exercise broad interpretive authority.

Thus, the default rule should be that courts can use broad contextual evidence, consequentialist analysis that models likely incentive effects on the parties, probabilistic models about likely assigned meaning, and engage in traditional jurisprudence in which courts consider equity and are able to invoke other legal principles outside the particular doctrinal area. The retention of such power is important in order for courts to police opportunism. Interpretive doctrine should be developed and applied without unduly restricting the role of the court in ways that parties would not have anticipated or wanted. The ability to interpret contracts to achieve reasonable outcomes, to invoke equity to avoid forfeiture, and to consider and avoid negative prospective effects should all continue to play a role in contract interpretation. At the same time, courts should refrain from ex post adjustment of contracts to achieve fairness if the negative incentive effects on parties would make the intervention inefficient.

Courts should be able to invoke reasonableness to avoid absurd results and to provide “escape routes” for parties, to imply terms of good faith even when not expressly agreed to, and to invoke norms or rules of law outside the particular field without parties needing to have the foresight to invoke such principles. Thus, in deciding how to interpret an express condition, or to decide on whether several words constitute an

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182 Email from Robert W. Gordon, Professor of Law, Yale University School of Law to author February 01, 2011 6:25 PM (on file with author).
183 Courts should feel free to invoke models of probability in asking what is the probability that parties drafting a contract were concerned with or assigned what kind of meaning to a particular term. They should use Bayesian analysis to assign meaning to a written term given realistic assessments of the parties’ drafting skills and to calibrate the interpretation according to such estimates.
184 See discussion of Jacob & Youngs infra Section VII.A.
185 Otherwise, parties will draft around it, adding to transaction costs. Thus, ex post judicial revision of contracts of the kind seen in the ALCOA case would not be permissible unless it is clear that both parties ex ante would have agreed to such revision as part of an interpretive rule that would maximize surplus and minimize cost across contracts for all classes of transactors going forward.
186 Schauer, supra note 6, at 516.
express condition or a promise, the court should be able to invoke legal principles that the parties have not expressly invoked. The burden should not be on parties to select into methods of contract interpretation to which courts have regularly subscribed. Because there is a strong bias against a change in the common law standard, courts should not lightly decide that the parties have chosen to forego many traditional interpretive tools without an express and knowing renunciation of such tools.

An interpretive rule should be crafted as an intervention choice, recognizing that there is an interpretive risk inherent in all contracts and that parties would be willing to subscribe to a rule *ex ante* if it would enhance the willingness of both parties to engage in exchanges. The concern that a broad interpretive rule will inevitably lead to uncertainty and greater costs in litigation and enforcement can be mitigated—at least if that rule is one that interprets terms by resorting to a justificational framework that invokes the pursuit of chosen consequences, such as minimizing the *ex ante* risks (costs) facing parties who use express terms.

**VII. Explaining Courts’ and the Restatement’s Departures from Textualism in Contracts: Empirical Evidence Offers a Challenge to the Formalists.**

Many doctrines and cases in Contract law cannot be explained by textualism or formalism. The illustrations in the next section from current doctrine and case law demonstrate instances in which courts broadly interpret text with extrinsic evidence or interpret text with reference to certain objectives even if the parties have not specifically delegated that interpretive authority to a court. In other cases, courts add terms to contracts even if not expressly agreed on. Any theory of contracts must explain the results in these cases or offer an explanation as to why courts persist in approaches which the textualists argue should be rejected since they increase the costs of contracting. Whether these doctrines and interpretive rules add or diminish costs will be discussed below.

**A. *Jacob & Youngs: Interpreting Conditions to Avoid Forfeiture: Whether Goals Should Affect Interpretation***

If courts should ignore objectives or goals in contract adjudication and give effect exclusively to the parties’ chosen means, then the court reached the wrong result in the famous case of *Jacob &

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187 *citing?*  
188 *See Kraus & Scott, supra* note 23, at 1046.
The court decided what effect, if any, to give to the express conditions based on an anti-forfeiture objective. Under the textualist/formalist approaches, since the parties did not invoke the broad interpretive authority of the judiciary, the court should have totally ignored forfeiture concerns and strictly enforced the condition. Despite the criticism courts face by textualists and formalists for invoking the anti-forfeiture principle, invoking it may improve welfare.

In *Jacob & Youngs*, the parties chose language that created a number of express conditions, including a condition of the installation of a particular brand of pipe (Reading). Textualists and formalists assume that commercially sophisticated firms deliberately choose language and terms that effectuate their goals. When the parties chose to delineate the pipe brand as a condition, they were choosing strict enforcement of the condition. Had the parties not wanted to opt for strict enforcement, they could have avoided express condition language or delegated interpretive authority to a court through the use of a term like “Reading quality pipe.”

In the opinion, Justice Cardozo chose to forego strict enforcement largely on the ground that doing so would lead to forfeiture since it would deprive the contractor of the final payment. The precise doctrine tells courts that when interpreting language that might be either a promise or a condition courts should take account of possible forfeiture. Using that approach, the court construed the language as creating a duty to use Reading pipe. The failure to use the correct brand of pipe would result in a breach of contract resulting only in damages but not in forfeiture since the owner would not be discharged from payment.

Textualists and Formalists criticize the result as one that will add to parties’ costs of contracting. They argue that if the court simply

190 *Id.* at 243-44 (“This is merely to say that the law will be slow to impute the purpose, in the silence of the parties, where the significance of the default is grievously out of proportion to the oppression of the forfeiture.”).
191 Kraus & Scott, *supra* note 23, at 1096 (suggesting that because “commercially sophisticated parties such as” the contractor in *Jacob & Youngs* deliberately chose an express condition with knowledge of its consequences (including the doctrine strictly enforcing express conditions), a court should enforce the condition). Scott and Kraus are worried that the Restatement and case law evince “a deep seated policy against the enforcement of conditions that create forfeiture ex post.” *Id.* Kraus and Scott argue that the courts overlook the sound commercial reasons for express conditions based on the difficulty of the verification costs that would be involved in one party, the owner, having to demonstrate the non-comparability quality of a specific pipe to a court *ex post*. What Kraus and Scott ignore is that the parties both would have wanted to control opportunistic behavior in order to mitigate a contractual hazard. Thus,
enforces the language denoting the brand of pipe, the owner will avoid the costs of proving that the pipe installed is inferior since any departure results in an automatic discharge. Textualists and formalists claim that if the court fails to adhere to this approach of strict textualism in the treatment of the condition in the contract, costs will necessarily rise.192

The textualists’ cost analysis is based on in part on determining who would bear the burden of proof. If the parties adopted an express condition and the court enforced the condition as it was written, it would “set out a precise rule that allows B [the owner] to verify performance or non-performance at relatively low cost.”193 Reaching a contrary result would add to the owner’s costs since he would be saddled with the burden of proving that the substitute pipe did not conform, a relatively high burden that would increase “back-end verification or enforcement costs.”194

However, the analysis of costs in Jacob & Youngs is more complicated than it initially appears. First, the textualist/formalist approach would ignore certain costs, which if accounted for, might change the conclusion as to whether a textualist approach would foster net improvements in welfare. The textualist/formalist analysis of costs ignores that there might be some residual uncertainty about whether the parties would want the clause of the express condition enforced under all circumstances,195 even in cases where it would lead to economic waste and forfeiture for one party. Since the contract contains a condition but does not specify whether it would apply in every case regardless of the circumstances, arguably there is an interpretive issue that requires a judicial resolution. Would the textualists want that ambiguity or unresolution resolved in favor of a forfeiture outcome? Would the

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192 See id. at 1094-96.
193 Id. at 1097.
194 Id.
195 See Shavell, supra note 24, at 289 (explaining that parties “often employ broad terms that do not reflect their wishes in particular circumstances (suppose that they specify that material A should be used in construction but that they would really prefer substituting material B if an unusual problem arises with A)”).
textualists want to deny any restitutionary recovery to the builder?\textsuperscript{196} What would the parties themselves want?

To decide if there are any circumstances that might justify the outcome in *Jacob & Youngs* and similar cases, all of the costs of an announced interpretive rule that denied any recovery should be considered. If a court were to deny any recovery based solely on whether there was a clause containing an express condition, that approach would allow one party to engage in opportunistic behavior and seize upon insignificant defects to gain a large windfall at the other party’s expense.

One could argue that when such costs are accounted for, both parties would not have wanted the court to deny any recovery. Such a result would have allowed the owner to avoid making payment despite having received substantially what he bargained for. If the interpretation of enforcement despite minor deviation were adopted, it would constitute an interpretive risk for all future transactors. Potential contractors might demand higher payment up front to deal with the interpretive risk of a court strictly enforcing conditions despite their trivial departure. That result is something that most owners would presumably want to avoid \textit{ex ante} since it would unnecessarily add to their cost of contracting especially if one could shift the burden of proving equivalence to the contractor.

The counterargument is built on the notion that sometimes it may be hard to verify to a court whether a particular matter is really equivalent. To avoid courts having to grapple with such complex equivalence issues, the parties may choose to adopt an express condition so that there is no inquiry into the magnitude of the departure. One way to deal with the owner’s reluctance to shoulder the cost of proving to a court that an item is not equivalent would be to reassign the burden of proof. One could shift the burden to the contractor to prove that the pipes were substantially equivalent.

Rearranging the burden of proof\textsuperscript{197} could thereby achieve the owner’s goal of avoiding costly back end enforcement costs and simultaneously diminish the opportunity for opportunistic behavior. Such a result could presumably maximize the gains from trade.

The analysis suggested here is consistent with the idea that parties would balance the costs of drafting with greater particularity and

\textsuperscript{196} Bill Whitford raised this point.
\textsuperscript{197} See Kostritsky, \textit{supra} note 2, at 158 (suggesting such a rearranged burden of proof).
the interpretive risk of not explicitly specifying whether the court should give effect to the condition no matter how insignificant the deviation or great the forfeiture. Part of the answer to that question lies in an analysis of how most parties in the population would resolve that question. That projection should then be used to interpret a contract using Bayes’s theorem. As Professor Yair Listokin explains:

Suppose that there are many more parties in the population who prefer pipe of Reading quality rather than Reading brand pipe. This means that when confronted with a contract that specifically calls for Reading pipe, it may be more likely that the contract stemmed from parties who wanted pipe of Reading quality (high prior) and drafted their contract poorly rather than from parties who wanted Reading brand pipe (low prior) and drafted their contract well. If this is the case, then the most likely bargain between the parties is pipe of Reading quality, in spite of the fact that the contract calls for Reading brand pipe.198

A similar application of Bayes’s theorem could be applied to population preferences regarding large forfeiture in the context of an express condition. If most parties would want to avoid such a result, then in interpreting the language of an express condition, the court should depart from a literal interpretation, adjusting the meaning of the contract according to the high prior. The court should presumably announce an

198 Listokin, supra note 3, at 361. Professor Listokin’s discussion of the probability of one meaning attaching rather than another pertains to a particular term (pipe quality) leads him to suggest that under some cases, the courts should veer away from the “natural reading” of the language toward an interpretation which takes the likely meaning attached by the general population. Id. at 365. The same analysis could be applied to the likely probability that parties would want the forfeiture term in a contract strictly enforced under all circumstances. One could surmise that the contract was drafted with a certain set of implicit assumptions about various states of the world. If all of those assumptions proved accurate, forfeiture under a natural reading of the contract result as the parties accepted that forfeiture would result under those assumptions. However, if those assumptions change and new information is provided, as for example, that the pipes are equivalent and a large forfeiture would result, the law would need to deal with that new information. “Although the intent of the parties is still to maximize wealth, we revise our hypothesis about what is a wealth maximizing strategy in light of this new information. With the passage of time, the role of forfeiture as a wealth maximizing strategy ought to change.” Email from Peter M. Gerhart, Professor of Law Case Western Reserve University School of Law to Juliet P. Kostritsky Professor of Law Case Western Reserve University (August 9, 2011).
interpretive rule for dealing with express conditions which also involve a potential forfeiture based on a similar projection of party preferences. The announced rule can then take account of the concern regarding high ex post costs when matters are highly unverifiable (as when the stipulated event that is the subject of a condition is a matter of personal taste). The rule should determine whether those costs should be evaluated differently in cases with matters that are more susceptible to objective measurement (such as the difference in two brands of pipe) and which also involve a large forfeiture potential, based in part on what most parties would prefer. The rule could also take account of cost concerns by shifting the burden of proof on the quality issue to the party seeking payment. The interpretive rule, as crafted, would take account of the danger of forfeiture and the potential for opportunistic behavior while remaining sensitive to the burden of proof issues for matters that are unverifiable to a court.

The actual case law in the area of conditions takes account of precisely these factors in a nuanced analysis. The courts seem to take account of the avoidance of forfeiture as a goal when deciding whether to literally enforce the conditions of the contract. Doing so in cases where there is large potential forfeiture and a readily verifiable minor deviation arguably results in a net improvement in overall welfare by deterring opportunistic behavior.

B. Residual Uncertainty: How Courts Take Account of Overall Objectives and Prospective Consequences in Contract Interpretation

The express terms of any contract may also leave residual uncertainty and require interpretation by the court. For example, an easement prohibited use of three-wheeled ATVs, but failed to cover or prohibit the use of four-wheeled ATVs which didn’t exist at the time of the contract. When the grantor of the easement sought to restrict the holder of the easement from using four-wheeled ATVs, the easement holder argued that the express terms did not expressly rule out four-wheeled ATVs and that they should therefore be permitted.199

This case raises the question of what the intervention choice should be. If it followed formalism and textualism’s dictates, the court should refuse to intervene beyond the express terms and should refuse to

199 This example comes from Steven J. Burton’s recent book on the interpretation of Contracts. See BURTON, supra note 43, at 168.
consider the parties’ objectives to interpret the contract. At the time that
the easement was drafted, four-wheeled ATVs were not in existence,
which explains why there was no express term covering the contingency
or the later arising condition of four-wheeled ATVs. The lack of such
vehicles may explain why the parties failed to adopt a clause forbidding
similar vehicles which might be developed in the future.

This is a case where the express term is meant to settle the
controversy in some way and yet one must still ask: in what way does the
express term settle the question? Using the textualist/formalist approach,
one would posit that the absence of a broad or open-ended term would
foreclose interpretation that looked to goals or ends beyond the
contractually chosen means. Yet, deciding that there is no interpretive
issue itself requires interpretation that cannot be settled by the express
terms. Therefore if the court refuses to intervene in that way, then it is
nonetheless a choice which must be justified.

One could argue that this residual uncertainty should be resolved
by consequentialist decisions about how much the four-wheeled vehicle
adds to dust/smoke/noise. That is what the court did by admitting
extrinsic evidence. Such an approach seems to make sense. Whether it
can be justified as an interpretive rule that will minimize the costs and
risks of contracting requires further analysis.

The parties could have decided that there was some interpretive
risk of not further specifying the kinds of vehicles that would be
prohibited on the easement, and not drafting the clause in such a way that
it took account of vehicles that were later developed. Since the parties
were not aware of four-wheeled vehicles at the time of contract
execution, they may not have realized that the clause in question would
later require interpretation beyond the express terms.

The question for the collective (judiciary, agency, and
legislature) is whether intervention using the parties’ objectives—a broad
interpretive rule admitting evidence beyond the “minimum evidentiary
base”—would minimize costs for the parties more than a literalistic
interpretation that excluded such objectives. In deciding what a court
should do, one should consider why the parties may have failed to try to
eliminate all interpretive risk. One could argue that the parties may have
decided that leaving the term unresolved as to the matter of later
developed vehicles would present little danger to the parties since courts
could readily expand the class of covered vehicles to achieve the
objective of reducing noise and dust. Literalism, on the other hand,

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would promote a kind of opportunistic behavior by the holder of the easement, yet another case where literal interpretation would act as a drag on gains from trade.

The rule should mimic what the parties would want in hypothetical bargain terms. The decision about intervention should depend on which approach best reduces costs for the parties and is most preferred by parties *ex ante*. *Ex ante*, the parties will prefer an interpretive rule that will minimize the costs of transacting. In cases where the risk of an event occurring (such as the development of a four-wheeled ATV) is not foreseeable, the parties might decide that pursuing further drafting is not worth the cost. This may be due to the interpretive risk that they face and because they can safely cease drafting, since a court could readily resolve such a straightforward issue at a low cost and determine what vehicles should be included within the parameters of a clause covering three-wheeled vehicles.

The literalistic approach will increase costs for all parties in the form of an unremedied opportunism. Parties will have to exert defensive costs to constrain such opportunism. Instead of being able to rely on a court to broadly interpret three-wheeled vehicles to cover four-wheeled vehicles, they may undertake the extra drafting costs to cover unforeseeable developments even if they would prefer to rely on a court to resolve such residual uncertainties. The question for the court is whether intervention beyond the express terms will minimize costs for the parties more than a decision not to intervene under the literalist approach. Intervention would be justified in cases: (1) where the objectives are readily ascertainable and self-evident from inquiring into the purpose of the clause (why were any all-wheeled vehicles prohibited in the first place?); (2) where the contract is not subject to ready manipulation by a party as would be the case in which a party would profit at the expense of the other by falsely inflating a term such as seller’s costs; and (3) where the court is convinced that intervention will minimize costs by preventing defensive expenditures.

For commercially sophisticated parties, courts in the Seventh Circuit and elsewhere look beyond a literal interpretation of contracts when doing so would maximize gain from trade and minimize transaction costs, even when they announce their intention of following a textualist interpretation. In *Abbott Laboratories v. Unilever United*..

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201 See Alan Schwartz J. Legal Stud. (198X)
Abbott purchased Sequoia Turner Corporation, a medical research and manufacturing company, from Unilever because it was in a better position to distribute Sequoia’s products than DuPont, Sequoia’s long-time distributor.\textsuperscript{203} Foreseeing that DuPont would retaliate, Abbott and Unilever contracted to jointly share all losses from the expected DuPont suit. Section 9.3 of their agreement stated that Abbott would “direct and manage any and all litigation related to . . . DuPont” notwithstanding anything to the contrary in Section 9.5.\textsuperscript{205} Section 9.5 provided that Abbott could not settle any lawsuits without approval from Unilever, and if Unilever disproved of the settlement, it assumed the defense of the action. DuPont sought an injunction against the change of distributor and filed suit. After Abbott settled with DuPont, Unilever refused to share the losses, claiming that Section 9.5 required their approval of the settlement.

Although the court employed New York law and announced its intention to “ask[] what the words in the contract” would have meant at the time of contracting, the court’s decision in fact seemed to turn on its desire to remedy the situation to promote trade and increase gains.\textsuperscript{206} The court’s analysis focused on the negative consequences of allowing a literal, non-contextual interpretation to govern the outcome, including the problem of moral hazard that would result if one party could take actions that would favor itself at great cost to the other party and defeat the overall purpose to share losses. If Unilever’s version of the contract was accepted, then Abbott would be “at Unilever’s mercy” because Unilever could have rejected the settlement and then unilaterally allowed DuPont’s injunction. Such a result would “have protected Unilever’s treasury at a great cost to Abbott” and would have the potential of defeating the purpose of the initial sale of Sequoia.\textsuperscript{207} Instead, the court found that Unilever was liable for joint losses with Abbott; thus reaching the result that made the most commercial sense.

\textbf{C. Trade Usage: When Should Trade Usage Govern Meaning? Should a Specific Opt-In be Required?}

Another contentious issue for the interpretation of contracts is whether parties need to specifically opt in for trade usages to govern meaning. The textualist approach would deprive the court of any interpretive authority to go beyond ordinary meaning without an explicit authorization by the parties to do so. Current law is to the contrary and

\textsuperscript{203} Abbott Labs. v. Unilever U.S., Inc., 45 F.3d 187 (7th Cir. 1994).
\textsuperscript{204} Id. at 188.
\textsuperscript{205} Id. at 189.
\textsuperscript{206} Id. at 190.
\textsuperscript{207} Id.
provides that unless specifically negated by the parties, trade meaning may be admitted to interpret or supplement parties’ agreements.  

The requirement of explicit party choice proposed by the textualists to govern trade usage in contract interpretation seems to mask the idea of judicial intervention. It makes the interpretive approach depend on party choice. The court, however, is choosing whether and on what basis it will go beyond the express terms of the contract and consider trade usages in ascertaining meaning. The court is announcing an interpretive rule regarding the degree of explicit choice required for parties wanting courts to consider trade usages in contract interpretation.

What interpretive rule should be adopted to govern trade usage and contract interpretation should not depend on whether a party expressly authorizes a court to go beyond the text, but rather on a consideration of which rule or opt out would minimize all costs of exchange for all future parties and promote growth.

One possible cost from the current rule (evidenced in the case law and in U.C.C. § 2-202) not requiring express opt in to trade usage is that some parties may strategically claim a private meaning that differs from ordinary meaning. Yet to determine whether those costs are great enough to justify an interpretive rule requiring express opt in, the costs of requiring parties to opt in must also be considered.

The costs of requiring parties to expressly opt in to trade usages include the transaction cost of knowing that the meanings that parties in the trade attach to words are different from the ordinary meanings that parties not in the trade attach to those same words. Because parties in the trade may assume that the trade meaning is the ordinary meaning, they may see no need to expressly opt in to a trade usage term in the contract. Requiring such express opt in provisions poses large transaction costs for parties in the trade.

The other cost from requiring parties to opt in is that parties may strategically and opportunistically rely on ordinary meaning to escape from the trade meaning whenever it turns out to be a bad deal. While there may be contrary cases in which the parties opportunistically rely on trade meaning, the cases most emblematic of this kind of strategic

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208 U.C.C. § 2-202, ___ cmt. 2 (year).
209 See supra note x.
210 For a discussion of the moral hazard problem that arises when parties claim a private meaning that differs from ordinary meaning, see Schwartz & Scott, Limits, supra note 30, at 586.
behavior seem to be “outlier” cases in which the evidence of the trade usage is so vague that it invites opportunistic behavior, such as when a fixed quantity is deemed to be merely an estimate under trade usage. The courts can easily police such opportunistic behavior when the party seeking to rely on a vague trade usage also takes advantage of a low fixed price and a market shift to suddenly sell more product. However, there are many cases in which courts invoke trade usage in a way that seems to deter rather than promote opportunistic behavior.

Often a party relying on plain meaning seems to be trying to escape from a trade usage that was definite and applicable for no other reason than that it was more advantageous to do so. The potential costs of this and other opportunistic behavior must be weighed in determining which interpretive rule, opt in or opt out, would minimize the costs of transacting. Certainly, if a default rule of ordinary meaning will promote opportunistic behavior, and the court could constrain that behavior with an opt out rule, then the parties might be inclined to prefer the opt out rule.

In considering the costs and the reduction in costs that might occur with a particular version of an interpretive rule (either opt in or opt out), one would also have to consider the effect that requiring an opt in rule would have in a class of cases where the trade usage at issue is specifically designed to control a form of opportunistic behavior. Absent an express opt in, the trade usage would not govern the outcome of those cases. That failure would generate costs in the form of uncontrolled opportunistic behavior unless the parties could effectively control the opportunism by other private strategies such as informal enforcement.

The decision to exclude valid trade usages that are universally adhered to and are designed to curb opportunism would generate costs that might deter future transactions and would be considered a cost of the exchange. Those costs could be mitigated by parties resorting to informal mechanisms. However, the informal mechanisms themselves have a cost which might outweigh the costs associated with a court announcing in advance an interpretive rule that would incorporate trade usages into contracts as part of interpretation. Moreover, to the extent that the informal mechanisms are not pervasive and robust in a certain factual setting, the cost to parties of denying effect to trade usages designed to deter opportunism might be that opportunism itself would remain unchecked. In such cases, courts should be able to incorporate trade usages because viewed except parties would want courts to be able to do so in order to police opportunistic behavior and maximize surplus. The parties ought to be able to bargain over the scope of review but not against a literal default meaning unless a broader view is explicitly
D. Section 45: Intervention Choice When No Express Terms

When no express terms are present to cover in any way a future event or circumstance, the question that may arise is whether the court should nevertheless add a particular term to the parties’ contract. In unilateral contracts, for example, courts face the issue of whether they should imply a term of irrevocability of the offer once performance by the offeree has begun.

The same justificational framework under an economic approach must resolve what a court should do when parties omit terms altogether and must consider what approach would best minimize the costs of contracting for the parties and thereby promote growth.

If the logic of textualism and formalism is accepted, and the parties have included no express term and delegated no authority to a court, a court should not intervene and should therefore refuse to imply a term of irrevocability. Presumably, if the parties had wanted a court to intervene in such cases they would have announced their intention by express delegation.

Yet, even if a court decides not to intervene by implying a term of irrevocability in unilateral contracts, it must justify that intervention choice. The question is whether collective intervention to refuse to imply a term or to supply a term of irrevocability would serve to better minimize transacting costs for the parties.

The risk in the unilateral contract situation is that once the offeree begins to perform, the offeror will either revoke the offer or engage in opportunistic behavior by making a less favorable deal once the offeree has sunk costs. If a court declines to intervene with an interpretive role offering protection, parties may react to this interpretive risk by negotiating express contractual protection in every case involving a unilateral contract. These negotiated protections are costly. The parties could also rely on reputational sanctions to police against the potential for opportunistic behavior by the offeror, a private strategy to protect against the risk. Finally, the parties could decline to begin performance in unilateral contracts without an express option, a move that would ensure that offerees are protected against lost reliance costs.

However, parties that fail to adopt an express term of

212 See Restatement (Second) of Contracts § 45(1).
irrevocability may do so because probabilistically they assume that the court will protect them from such opportunistic behavior regardless of whether such a term is included in the express contract. Because there are many instances in which a court protects against such opportunistic behavior (as by implying terms of good faith to prevent parties from acting opportunistically to recapture foregone opportunities), they may assume that no specific clause is needed.

The alternative approach, which the Restatement and case law accept, supplies a default rule that bars revocation once part performance has begun. Ex ante, when performance has been requested as the exclusive mode of acceptance, the offeree knows that he can safely begin performing without fear of revocation. This reduces one type of interpretive risk. Similarly, the offeror would be interested in having the court announce the rule of irrevocability in advance in order to encourage offerees to rely on unilateral contracts rather than engaging in costly preventative measures.

The collective intervention solves a recurring problem of the potential opportunistic exploitation of sunk costs in unilateral contracts. Although it is possible to think that the market might solve the problem on its own by having promisees screen for reliable offerors and pay less for offers that denied protection for partial performance, the pricing of such offers might be complicated, thereby making market protection difficult. The scenario discussed above presents a case in which a court can safely assume that the majority of parties would prefer to save on transaction costs by supplying a default rule that would protect against opportunistic behavior at a low cost. Those offerors who want to opt out of such protection can do so, giving offerees an opportunity to negotiate a lower price for such reduced protection.

VIII. Further Applications: The Chrysler Bankruptcy

Analogous questions of how courts should proceed when interpreting a term arise in the context of the interpretation of bankruptcy statutes. In the Chrysler case, after Chrysler entered Chapter 11,

214 See § 45(1).
215 William Whitford provided this insight.
216 Id.
several courts deciding the case\textsuperscript{218} grappled with how the word “sale”\textsuperscript{219} should be construed when the particular term is not crisply clear enough to determine whether what was done was a permissible sale or not. The term’s intractability required interpretation by the court in the context of several Bankruptcy Code provisions.

The Bankruptcy Code governs what happens to companies that go into bankruptcy. It provides a mechanism for those companies to reorganize under Sections 1121 through 1129.\textsuperscript{220} If a company chooses to reorganize, it secures protection against its creditors from the bankruptcy court. If reorganization rather than liquidation occurs,\textsuperscript{221} the company must comply with the provisions of Section 1129,\textsuperscript{222} the most significant of which “requires that the plan complies with the usual priorities, absent creditor consent to a plan deviating from those priorities.”\textsuperscript{223} Those priorities give preference to secured creditors over unsecured creditors and to unsecured creditors over bondholders.\textsuperscript{224}

\begin{footnotesize}
\begin{enumerate}
\item The Chrysler bankruptcy addressed the question of whether a sale of Chrysler’s assets was a permissible sale under 11 U.S.C § 363 (2006) or whether it was impermissible under the statute because it failed to afford certain classes of secured creditors the protections afforded creditors by the bankruptcy law under Chapter 11. The rising popularity of § 363 sales has engendered a sharp debate in the scholarly and popular press. \textit{See, e.g.}, Todd J. Zywicki, \textit{Chrysler and the Rule of Law}, WALL ST. J., May 13, 2009, at A19, \textit{available at LEXIS} (discussing the divergence from the rule of law in the Chrysler case and how it may affect future businesses); Mark J. Roe & David Skeel, \textit{Assessing the Chrysler Bankruptcy} (INST. FOR LAW AND ECON., U. OF PENN. LAW SCHOOL, Research Paper No. 09-22, 2009), \textit{available at http://ssrn.com/abstract=1426530} (arguing that the Chrysler bankruptcy does not comply with good bankruptcy practice); Mike Spector, \textit{The Quickie Bankruptcy --- More Companies Enter Court and Exit, in a Flash}, WALL ST. J., Jan. 5, 2010, at C1 (discussing the effect that the Chrysler bankruptcy has had on bankruptcy law).
\item A sale under § 363 of the Bankruptcy Code allows that “[t]he trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.” 11 U.S.C § 363(b) (2006).
\item 11 U.S.C. §§ 1121-1129 (2006) (covering who may file a plan, classifications of claims and interests, the contents of the plan, impairments of claims and interests, post-petition disclosure and solicitation, acceptance of the plan, modification of the plan, the confirmation hearing, and confirmation of the plan).
\item Note that if liquidation occurs under Chapter 7 rather than reorganization, the usual priorities must be complied with under § 726. \textit{See} 11 U.S.C. § 726 (2006).
\item 11 U.S.C. § 1129(a) (2006) (noting that a court shall only confirm a reorganization plan if all of the requirements of § 1129 are met).
\item Roe & Skeel, \textit{supra} note 218, at 6.
\end{enumerate}
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At the same time, the Code permits a bankrupt entity to sell assets under Section 363 without the consent of creditors as long as the bankruptcy court approves the sale. There are some instances in which a bankrupt debtor should be allowed to sell an asset for cash without creditor consent, particularly if that asset is deteriorating in value and its value might be dissipated if all of the creditors had to agree on the sale. Presumably, it would be better to permit such sales rather than to totally deprive the bankrupt estate of the asset, which might happen if consent had to be obtained given the exigencies of a deteriorating asset.

The danger with Section 363 sales is that if they are significantly broadened, companies could use a Section 363 sale as a way of avoiding compliance with the priorities among creditors that would otherwise be required under Section 1129. That concern led courts to develop doctrine that prohibited sales that were reorganizations in fact and part of an effort “to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan in connection with the sale of assets.”

The Chrysler bankruptcy involved a sale under Section 363.

227 Ind. State Police Pension Trust v. Chrysler L.L.C. (In re Chrysler LLC), 576 F.3d 108, 113 (2d Cir. 2009) (citing Holders v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063, 1066-68 (2d Cir. 1983)) (noting that § 363 originated from the Bankruptcy Act of 1867, which allowed a debtor’s assets to be sold if the assets were perishable, liable to deteriorate in value, or would otherwise be wasted).
228 “[T]here are times when it is more advantageous for the debtor to begin to sell as many assets as quickly as possible in order to insure that the assets do not lose value.” Chrysler, 722 F.2d at 133-34 (quoting Fla. Dep’t of Revenue v. Piccadilly Cafeterias, Inc., 128 S. Ct. 2326, 2342 (2008)) (Breyer, J., dissenting).
229 Id. at 114 (“Pushed by a bullying creditor, a § 363(b) sale might evade such requirements as disclosure, solicitation, acceptance, and confirmation of a plan.”); Roe & Skeel, supra note 218, at 9 (arguing that §363 sales could circumvent Chapter 11 protections); Richard A. Epstein, The Deadly Sins of the Chrysler Bankruptcy, FORBES ONLINE, May 12, 2009, available at http://www.forbes.com/2009/05/11/chrysler-bankruptcy-mortgage-opinions-columnists-epstein.html (arguing that “[u]psetting this fixed hierarchy [of priority] among creditors is just an illegal taking of property from one group of creditors for the benefit of another, which should be struck down on both statutory and constitutional grounds”).
“Old” Chrysler sold substantially all of its assets to a new corporation, “New Chrysler,” for $2 billion. This sale resulted in secured creditors receiving only 29 cents for every dollar of debt they held. “New Chrysler . . . then assumed the old company’s debts to the retirees, most dealers and trade creditors. The unsecured claims of the retiree’s benefits plan were replaced with a new $4.6 billion note as well as 55% of the new company’s stock.”

The Indiana Pensioners as secured creditors objected to the plan and sought an immediate stay of the bankruptcy court’s approval of the sale of Chrysler’s assets. The Indiana Pensioners argued that the transaction was a “sale” in name only, amounting to an “impermissible, sub rosa plan of reorganization.” After hearing arguments on the expedited appeal, the Second Circuit affirmed the judgment of the lower bankruptcy court. After weighing the need for Section 363 sales in some instances and the concerns that such sales may sidestep key features of the Chapter 11 process, the court relied on its prior holding in Lionel that required a “good business reason” for a sale under Section 363. The Second Circuit held that the bankruptcy court’s findings that “the only possible alternative to the sale was an immediate liquidation that would yield far less for the estate—and for the objectors” constituted a good business reason for the Section 363 sale by “prevent[ing] further,

231 Chrysler, 576 F.3d at 111-12.
232 Roe & Skeel, supra note 218, at 5; Spector, supra note x. Note that under a § 363 sale, assets may be sold “free and clear of any interest” in the assets if the interest holder consents to the sale. See 11 U.S.C. § 363(f) (2006). Although the petitioners in the Chrysler case did not personally consent to the release, the Second Circuit found that the consent was validly given by a collateral trustee who had such authority. See Chrysler, 576 F.3d at 119-20.
233 Roe & Skeel, supra note 218, at 5. See also Spector, supra note x.
234 Chrysler, 576 F.3d at 111.
235 Id. at 113. The Indiana Pensioners argued that the New Chrysler will be the Old Chrysler in almost every respect, including its name, its employees and management, as well as the types of vehicles it produces. Id.
236 Id. at 112, 127. The Second Circuit entered a written order affirming the Bankruptcy Court’s decision on June 5, 2009 and scheduled the stay to be lifted on June 8, 2009 or upon a denial of a stay by the Supreme Court. On June 8, 2009, Justice Ginsberg issued a temporary stay but on the following day the Supreme Court issued a per curiam denial of the petition for emergency stay. The Second Circuit issued a formal opinion of the case on August 5, 2009. See id. at 111-12; Pet. for Writ of Cert. at 2, Ind. State Police Pension Trust v. Chrysler L.L.C., 130 S. Ct. 1015 (2009), (No. 09-285), 2009 WL 2864378 (generally describing procedural history).
237 Holders v. Lionel Corp. (In re Lionel Corp.), 722 F.2d 1063 (2d Cir. 1983).
238 Chrysler, 576 F.3d at 114.
unnecessary losses.”\textsuperscript{239} The Indiana Pensioners then petitioned for a writ of certiorari. In an interesting turn of events,\textsuperscript{240} the Supreme Court granted certiorari but then vacated the judgment of the Second Circuit and further ordered the appeal dismissed as moot, presumably since the sale had already closed.\textsuperscript{241}

In construing whether the Chrysler sale was permissible under Section 363 and existing case law, the various courts had to determine whether the sale violated the purpose of other provisions in bankruptcy law regarding the necessity for the approval of plans of reorganization. Ambiguity is created by the context, in the sense of the other sections of the Bankruptcy Code which would not permit sales of assets without a reorganization complying with Sections 1129 et seq. When such statutory ambiguity exists, at least if the statute becomes part of the terms of every creditor-debtor contract, this Article suggests that a court should employ a consequentialist interpretation of the statute. The court should consider the \textit{ex ante} effects of the interpretive rule on the origination of debtor-creditor transactions in the future, not to mention the wealth distribution for already existing relationships.

The \textit{Chrysler} case and the statutory interpretation of Sections 363 and 1129 should not be resolved without a consideration of how such interpretation will affect asset-based lending relationships in the future. In deciding whether the exception for 363 sales should encompass

\textsuperscript{239} \textit{Id.} at 118-19.

\textsuperscript{240} The intended meaning and purpose of Supreme Court’s “summary disposition” of the case has caused some confusion in the legal world. \textit{See, e.g.}, Steve Jakubowski, \textit{US Supreme Court Drops Bombshell “Summary Disposition” Vacating 2d Circuit’s Chrysler Decision}, Dec. 14, 2009, \url{http://www.bankruptcylitigationblog.com/archives/cat-us-supreme-court-cases.html} (questioning the Court’s rationale for vacating and dismissing the case as moot).

\textsuperscript{241} Ind. State Police Pension Trust v. Chrysler L.L.C., 130 S. Ct. 1015 (2009). “\textit{Chrysler} could become the template for the next generation of large scale corporate reorganizations. . . If it becomes the pattern, \textit{Chrysler} could displace the traditional Chapter 11 process, potentially affecting both lending markets and vulnerable nonfinancial creditors adversely.” Roe & Skeel, \textit{supra} note 218, at 4. \textit{See also} Ashby Jones & Mike Spector, \textit{Creditors Cry Foul at Chrysler Precedent}, WALL ST. J., June 13, 2009, at B1, \url{available at LEXIS} (stating that if the \textit{Chrysler} trend is followed it could “make investors demand higher interest rates on debt amid uncertainty over how they might fare should the firm encounter financial difficulties”); \textit{The Changing Face of Bankruptcy}, CFO MAGAZINE, Aug. 11, 2009, \url{available at 2009 WLNR 16169064} (noting that other companies facing Chapter 11 may be following Chrysler’s lead with General Motors, Midway Games, Nortel, and Tropicana Atlantic City Casino all initiating § 363 sales since the beginning of 2009).
the precise facts of the Chrysler situation when (1) the sale was for substantially all of the debtor’s assets, (2) the government was a creditor with a self interest which may have led it to ignore the claims of the secured lenders with priority, and (3) the resulting bankruptcy would result in the unsecured creditors who were favored by the Treasury Department (the UAW) faring better than secured creditors (in contravention of long standing bankruptcy priority rules), the court should have considered those *ex ante* effects on future debt transactions. 242 Unless courts account for those effects, future creditors will not know how to assess the risk involved in lending. There will be greater uncertainty about the extent to which the government will upset traditional priority rules in the future. That uncertainty will add to future risk for creditors and it will either dampen the willingness of future lenders to lend or incentivize them to impose harsher terms to account for the increased risk.

IX. Conclusion

When contracts remain ambiguous or incomplete, courts and scholars must confront the inevitable question of when intervention in private contracts is justified. To deal with the unresolution or residual uncertainty, the new textualists suggest that any intervention would be a fool’s errand. Their position amounts to an unvarying posture that any party asking for an additional term or a broad interpretation will always lose.

Recognizing that there is an interpretive risk in all contracts, courts should adopt an interpretive methodology that would enhance the willingness of both parties to engage in exchanges. To achieve that goal, courts should focus on how the interpretation adopted would increase or decrease interpretation risks (costs) over time to different classes of transactors. By tailoring and applying interpretive rules, courts can (and do) promote increases in net welfare in a range of cases and contexts examined in this article. If the prospect of adding a term or even overriding a term would prevent opportunistic behavior or catastrophic consequences to both parties, then courts can intervene in a way that maximizes surplus and would be preferred by both parties. An effective model of contract interpretation should use the probabilistic thinking of the parties, with respect to (1) implicit assumptions about underlying meaning that might affect the choice of certain

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242 In their opinions regarding the Chrysler bankruptcy and the § 363 motion, neither the Bankruptcy Court nor the Second Circuit addressed the potentially devastating effect that their decisions could have on the future extension of credit by secured lenders. *See generally, Chrysler*, 576 F.3d 108; *In re Chrysler*, 405 B.R. 84.
words or phrases 2) the parties’ likely goals for contracting and 3) the set of implicit assumptions about various states of the world (including the future). These probabilistic mechanisms are crucial in interpreting contracting because our brains are hard wired to use these tools and it is the only way courts can form a basis for deciding on meaning in a contract. The court must weigh all of these in deciding what meaning would best achieve the parties’ intended meaning and overall goals. Thus, a consequentialist framework must be part of any attempt to decide on an optimal interpretive strategy. The alternative textualist/formalist approach suggesting a test which requires parties to expressly delegate interpretive authority in order for the court to exercise broad interpretive authority, will result in the radical result of parties being foreclosed from having courts acting as ordinary courts customarily do in adjudicating cases, a result that is contrary to the likely expectations of the parties.

The Article concludes that the same economic considerations informing contract interpretation should be applied outside the contracts context to the interpretation of federal statutes in the Chrysler bankruptcy in a way that had been neglected by the Second Circuit.

Parties often acquiesce in this approach since there are few instances in which parties expressly adopt a textualism rule in their contractual agreements. The failure to regularly employ such terms provides further evidence that parties do not prefer textualism. Courts are correct not to insist on a unitary method of contract interpretation.\textsuperscript{243}

\textsuperscript{243} Parties occasionally draft express contract language providing for strict textualism in interpretation. The inclusion of such explicit provisions in some contracts indicates that parties do not expect courts to adhere to strict textualism absent such express language. Given the rarity with which such provisions are included in contract language, most parties do not desire such strict textualism when a court is interpreting a contract. For an example of a contract that contains a rule providing for strict textualism, see Alliance Agreement, E.I. du Pont de Nemours and Company – EarthShell Corp., July 25, 2002, available at http://contracts.oncle.com/earthshell/dupont.collab.2002.07.25.shtml (“The Parties’ legal obligations under this Alliance Agreement are to be determined from the precise and literal language of this Alliance Agreement and not from the imposition of state laws attempting to impose additional duties of good faith, fair dealing or fiduciary obligations that were not the express basis of the bargain at the time this Agreement was made.”).
Introduction

[Text]^{244}