The Law and Economics of Contract Interpretation

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1. Introduction

In the economic analysis of contract law, a complete contingent contract is a hypothetical contract that anticipates every possible circumstance relevant to contract performance and specifies in complete detail all rights and duties of each party in response to these circumstances.[1] A complete contingent contract requires no interpretation, and the court's role is limited to enforcing it according to its terms. No real contract ever achieves this level of completeness, however. In the real world of high transaction costs and bounded rationality, ambiguous or incomplete contracts are a frequent source of litigation.

In the law and economics literature, contract interpretation is usually defined as the undertaking by a court to determine what the terms of a contract are, or should be understood to be.[2] In law, interpretation of express terms is often distinguished from construction, the process of identification of implied terms.[3] In law and economics, the tasks of identifying the contract terms and clarifying their meaning are often analysed together.[4] The focus is on the parties' preferences for a certain interpretive regime, and on the effect that the interpretive norms have on the parties' ex ante and ex post costs and behaviour. It is generally agreed that the process of determining the content and meaning of contractual terms should be goal neutral: a court resolving an interpretive dispute should aim to recover the parties' intentions, whatever those intentions were at the moment of contract formation.[5] Goal neutrality is often justified as an extension of the principle of freedom of contract. If parties are allowed to create their own contract, the interpreter's role should be restricted to determining the parties' intentions prospectively and objectively.[6] In determining the parties' intentions, an interpreter should pay attention to the parties' contractual ends (the shared objectives pursued by the

[1] S. Shavell, 'Damage Measures for Breach of Contract' (1980) 11 *Bell Journal of Economics* 466, 468.
[2] R. A. Posner, 'The Law and Economics of Contract Interpretation' (2005) 83 *Texas Law Review* 1581, 1582. It should be noted that in common law the process of interpretation is objective – the courts aim to identify what reasonable contractual parties in similar circumstances would have agreed to. In contrast, civil law jurisdictions tend to focus on the subjective intentions of contracting parties (G. McMeel, *The Construction of Contracts: Interpretation, Implication and Rectification*, 2nd ed. (Oxford: Oxford University Press, 2011) 111). This chapter reviews the economic literature on contract interpretation and does not engage with the legal issues arising in particular legal traditions or jurisdictions.
[3] J. Morgan, *Great Debates in Contract Law*, 2nd edn (Palgrave Macmillan, 2015), 114-119; E. Patterson, 'The Interpretation and Construction of Contracts' (1964) 64 *Columbia Law Review* 833.
[4] G. M. Cohen, 'Implied Terms and Interpretation in Contract Law' in B. Bouckaert and G. De Geest (eds), *Encyclopedia of Law and Economics* (Cheltenham, UK: Edward Elgar, 2000), vol. III, 79; R.A. Posner, 'Contract Interpretation', above n. 2, 1586 (stating that, although gap filling and disambiguation may place different demands on courts, both are interpretive issues in the sense that they are efforts to determine how the parties would have resolved the issue had they foreseen it); E. A. Posner, 'The Parol Evidence Rule, the Plain Meaning Rule, and the Principles of Contractual Interpretation' (1998) 146 *University of Pennsylvania Law Review* 533, 559-60 (arguing that there is no theoretical justification for adopting different regimes with respect to incompleteness and ambiguity).
[5] A. Schwartz and R. E. Scott, 'Contract Interpretation Redux' (2010) 119 *Yale Law Journal* 962, 964.
[6] See e.g. J. S. Kraus, 'Philosophy of Contract Law' in J. Coleman et al (eds.), *The Oxford Handbook of Jurisprudence and Philosophy of Law* (Oxford: Oxford University Press, 2004) 687; A. Schwartz and R. E. Scott, 'Redux', above n. 5, 937.

parties in entering the contract) as well as to the means they chose to determine those ends (their preferred interpretive method).[7]

A related justification for a goal-neutral interpretive framework is economic efficiency. Parties enter commercial contracts in order to maximise their joint gain. This entails agreeing to terms that maximise their joint surplus, and agreeing on a division of the surplus via the contract price.[8] Parties rarely bargain ex ante on every possible contingency that may affect performance over the life of the contract. When the transaction costs of negotiating, drafting and monitoring a complete contract are higher than the expected benefits of completeness, parties leave gaps in their contracts. They invest in contract writing only to the extent needed for courts to find the correct answer, on average, and rely on courts to fill in the remaining gaps. Courts reduce the parties' transaction costs and maximise the utility of their relation by interpolating the terms the parties themselves would have agreed to, had they bargained over that matter.[9] In determining these terms, courts often use majoritarian defaults, which are the terms that most parties in similar circumstances would choose if contracting were costless. For example, courts will sometimes read into a contract a best-efforts clause, except when the parties expressly excluded such a clause, or will excuse non-performance based on impossibility, impracticability or frustration, unless the contract expressly precludes this possibility.[10] When the population of similarly situated parties is narrow, the majoritarian default becomes a tailored default that follows more closely the particular characteristics of the contractors.[11] Thus, in determining the missing terms by reference to the parties' hypothetical bargain, the courts further the parties' objective of maximising their contractual surplus. This process of interpolation decreases the parties' ex ante costs and the risks of ex post interpretation error.[12] Nonetheless, majoritarian or tailored defaults are not always efficient gap-fillers. In certain cases, courts respond to contractual incompleteness by providing penalty defaults (such as the *contra proferentem* rule, or the rule that only foreseeable damages will be awarded). Penalty defaults induce contracting parties to invest more in the ex ante transaction costs by disclosing private information or bargaining explicitly with regard to a particular matter, in order to avoid the less favourable default.[13]

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[7] A. W. Katz, 'The Economics of Form and Substance in Contract Interpretation' (2004) 104 *Columbia Law Review* 496, 521.

[8] A. Schwartz and J. Watson, 'Conceptualizing Contractual Interpretation' (2013) 42 *The Journal of Legal Studies* 1, 2.

[9] A. Schwartz and R. E. Scott, 'Redux', above n. 5, 945.

[10] R.A. Posner, 'Contract Interpretation', above n. 2, 1585.

[11] C. Goetz and R. E. Scott, 'The Limits of Expanded Choice: An Analysis of the Interactions between Express and Implied Contract Terms' (1985) 73 *California Law Review* 261; D. Charny, 'Hypothetical Bargains: The Normative Structure of Contract Interpretation' (1991) 89 *Michigan Law Review* 1815. For a discussion of the difficulties associated with identifying and implementing majoritarian, tailored and penalty defaults see I. Ayres, 'Default Rules for Incomplete Contracts' in Peter Newman (ed.), *The New Palgrave Dictionary of Economics and the Law* (New York: Stockton Press, 1998), vol. I, 585; J. Johnson, 'Strategic Bargaining and the Economic Theory of Contract Default Rules' (1990) 100 *Yale Law Journal* 615; E.A. Posner, "Economic Analysis of Contract Law after Three Decades: Success or Failure?' (2003) 112 *Yale Law Journal* 829.

[12] A. Schwartz and R. E. Scott, 'Contract Theory and the Limits of Contract Law' (2003) 113 *Yale Law Journal* 541, 544; C. Goetz and R. E. Scott, 'The Limits of Expanded Choice', above n. 11, 262.

[13] I. Ayres and R. Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules' (1989) 99 *Yale Law Journal* 87; L. Bebchuk and S. Shavell, 'Information and the Scope of Liability for Breach of Contract: The Rule of *Hadley v. Baxendale*' (1991) 7 *Journal of Law Economics and Organization* 284; I.

A significant part of the law and economics literature on contract interpretation focuses on the most appropriate method the courts should use to retrieve the parties' intention: the textualist (or formalist) interpretation, which emphasises the primacy of ex ante contract design, and the contextualist (or purposive) interpretation, which focuses on ex post adjudication by courts. An emerging strand of research seeks to move beyond the relative merits of textualism and contextualism as universal interpretive regimes, and emphasises the importance of interpreting contracts using the methodology that best suits the circumstances of each contract. With limited exceptions, the methodology that meets this requirement is the one chosen by the parties, or, failing that, the one that reasonable parties in their circumstances would have preferred.[14] Contractual parties' preferences over interpretive rules are heterogeneous, and are influenced by factors such as the expected ex ante and ex post transaction costs, their degree of sophistication, the nature and duration of their relationship, the novelty and riskiness of their project, the need to leave a complete and accurate record of their bargain, the need to deter opportunism, or the need to reduce the risk of court error. Thus, in this view, the desirability of an interpretive regime depends on the parties' rational preferences and the attributes of the underlying transaction, and not solely on the independent merits of textual or contextual interpretation.

The need for flexibility in the application of interpretive methods is a normative insight of the emerging law and economics literature on contract interpretation. In many jurisdictions, the applicable interpretation rules are unitary and mandatory, in the sense that a given legal or judicial choice for a textualist or contextualist method applies across all types of contracts, and contracting parties cannot instruct courts to apply a different method.[15] To advance the principle of goal-neutrality in interpretation and to respect the parties' freedom to choose their contractual means and ends, it is submitted that, from an economic theory perspective, courts should adjust their methodology to reflect the parties' intentions either to regard their contract as complete (entire agreement clause), or to regard it as incomplete and rely ex post on relevant context to fill in the contractual gaps. The remaining part of this chapter is structured as follows. Section 2 summarises the main features of textualism and contextualism. Section 3 is an in-depth analysis of the relations between ex ante or ex post transaction costs and the optimal interpretive regime. Section 4 concludes.

Ayres, 'Ya-Huh: There Are and Should be Penalty Defaults' (2006) 33 *Florida State University Law Review* 589.

[14] S. Bayern, 'Contract Meta-Interpretation' (2016) 49 *The University of California, Davis Law Review* 1097, 1101. Respecting the parties' choice of interpretive regime does not mean that all aspects of the interpretive regime should be fully under their control. Rules such as *contra proferentem*, the formal requirements for enforceability of promises, or mandatory rules regarding evidence should not be under the parties' control (ibid. 1139-1142).

[15] Parties can choose indirectly among interpretive regimes by choosing the jurisdiction to govern their contract or by choosing between courts and private arbitration (A. W. Katz, 'Form and Substance', above n. 7, 508-9).

2. Interpretive methodologies: textualism and contextualism

Legal commentators have long debated over the relative merits of the textual and contextual methods of interpretation.[16] In the textualist interpretation method, the contract is regarded as the primary evidence of the parties' understanding. The contract is presumed to be complete, if it appears final and complete on its face. More ambiguous extrinsic evidence, such as previous understandings or industry norms and customs, is excluded.[17] Textualist jurisdictions give a presumptively conclusive effect to merger or integration clauses and, in their absence, presume that the contract is fully integrated if it appears to be complete (the 'hard' parol evidence rule).[18] Textualism is often associated with literalism, which gives contractual terms a plain language meaning that cannot be contradicted at the adjudication stage by contextual evidence supporting a different meaning.[19] Thus, textualism rejects the relevance of the social aspect of contracting, and requires "separation of law from life, of the meaning of the text from its context."[20] In its moderate form, textualism does not reject entirely the importance of context.[21] Instead, context is embedded in contract design by giving the parties, not the court, the power to decide the extent to which a court can consider context at the enforcement stage.[22]

Traditionally, textualism has been defended on grounds of freedom of contract and autonomy of contractual parties. By setting clear and predictable rules, textualism operates as a safeguard against the state infringing on individual choice.[23] The interpretive regime is thus a mechanism for allocating decision-making powers among various groups and institutions.[24] Formalism restricts the courts' discretion and prompts them to uphold the bargain of the parties instead of creating a new one.[25] It inculcates the view that sometimes it is appropriate for judicial decision makers to recognise their lack of jurisdiction and to defer to private

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[16] The debate between the two schools of thought has deep historical roots. See P. Stein, 'The Two Schools of Jurists in the Early Roman Principate' (1972) 31 *Cambridge Law Review* 8, 17-18 (discussing an analogous debate on interpretation in Roman law between the Sabinian and Proculian schools of jurists). For an detailed discussion of the development and main critiques of the two interpretive methods see A. Barak, *Purposive Interpretation in Law* (Princeton: Princeton University Press, 2011), Chrs 10 and 11.

[17] C. Mitchell, *Interpretation of Contracts* (London: Routledge, 2007) 123. See also J. Steyn, 'Does Formalism Hold Sway in England' (1996) 49 *Current Legal Problems* 43, 44; M. Stone, 'Formalism' in J. Coleman et al (eds), *The Oxford Handbook of Jurisprudence and Philosophy of Law* (Oxford: Oxford University Press, 2004) 173; A. W. Katz, 'Contract Theory - Who Needs It?' (2014) 81 *University of Chicago Law Review* 2043.

[18] R. Gilson, C. Sabel and R.E. Scott, 'Text and Context: Contract Interpretation as Contract Design' (2014) 100 *Cornell Law Review* 23, 43.

[19] C. Mitchell, *Interpretation of Contracts*, above n. 17, 93.

[20] O. Ben-Shahar, 'The Tentative Case against Flexibility in Commercial Law' (1999) 66 *University of Chicago Law Review* 781, 781. Parties are encouraged or constrained to write complete contracts by the use of penalty defaults (G. M. Cohen, 'Interpretation in Contract Law', above n. 2, 82).

[21] See C. Sunstein 'Must Formalism Be Defended Empirically?' (1999) 66 *University of Chicago Law Review* 636, 645 (stating that formalism is "a doomed enterprise if it is an effort to give meaning to terms apart from cultural understandings and context.").

[22] R. Gilson, C. Sabel and R.E. Scott, 'Text and Context', above n. 18, 43.

[23] A. W. Katz, 'Form and Substance', above n. 7, 514, See also N. MacCormick, *Rhetoric and the Rule of Law: A Theory of Legal Reasoning* (Oxford: Oxford University Press, 2005), 127; M. J. Trebilcock, *The Limits of Freedom of Contract* (Cambridge, Mass: Harvard University Press, 1997), 55; R. E. Barnett, 'A Consent Theory of Contract' (1986) 86 *Columbia Law Review* 269, 291-319; R. E. Barnett, 'The Sound of Silence: Default Rules and Contractual Consent' (1992) 78 *Virginia Law Review* 821, 857-60.

[24] C. Sunstein, *Legal Reasoning and Political Conflict* (Oxford: Oxford University Press, 1998), 168-169.

[25] C. Mitchell, *Interpretation of Contracts*, above n. 17, 101.

ordering, even when they believe that their own judgment is preferable.[26] Thus, the fundamental question in relation to interpretation is determining whether the parties have withdrawn from the court the opportunity to give a contextual interpretation of their agreement.[27]

The traditional formalist view engaged with difficult normative issues of legitimacy and decision-making authority. In recent years, the formalist argument has been recast in economic terms. This new trend is often referred to as neoformalism or anti-anti-formalism.[28] Neoformalism argues that a default textualist regime is better suited to promote economic and practical goals such as efficiency, procedural fairness, or public accountability. This recent wave of economically influenced scholarship analyses the relative merits of textualism and contextualism using economic tools and concepts, such as rational behaviour, transaction costs, opportunism, or information asymmetry.[29] An important strand of neoformalist research aims to justify textualism on empirical grounds, rather than on grounds of theory or principle.[30] By moving away from difficult arguments about legitimacy, neoformalism refocuses the debate on the pragmatic considerations underpinning why contracting parties favour a formal interpretative regime over a substantive one. For this reason, many neoformalists do not regard their position as the antithesis of contextualism. Their concern is with economic incentives and choices, rather than with contract as a social institution. The issue is not which interpretive rules yield more accuracy, but which interpretive defaults best reflect the parties' preferred trade-offs among accuracy in interpretation, contract-writing costs, and contract enforcement costs.[31]

Contextualism holds that the goal-neutral objective of recovering the parties' intentions is best achieved if courts are allowed to access a broad evidentiary base.[32] Contextualism views contracts primarily as social phenomena, and contract incompleteness as unavoidable and desirable. Courts recover the reasonable expectations of the contracting parties by taking into consideration elements of the social and commercial context of the agreement, such as the parties' past practices, their course of performance, or the conduct of similarly situated parties (trade customs).[33] In contextualist regimes, a contract that appears final and complete on its face, or an express merger clause declaring the contract to be integrated, are usually regarded as raising only a rebuttable presumption of integration, which

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[26] F. Schauer, 'Formalism' (1988) 97 *Yale Law Journal* 509, 543-44.
[27] W. Woodward, 'Neoformalism in a Real World of Forms' (2001) *Wisconsin Law Review* 971, 975.
[28] D. Charny, 'The New Formalism in Contract' (1999) 66 *University of Chicago Law Review* 842; R. E. Scott, 'The Death of Contract Law', (2004) 54 *University of Toronto Law Journal* 370; R. E. Scott, 'The Case for Formalism in Relational Contract' (2000) 94 *Northwestern University Law Review* 847; J. Murray 'Contract Theories and the Rise of Neoformalism' (2002) 71 *Fordham Law Review* 869; T. C. Grey, 'The New Formalism' Stanford Law School, Public Law and Legal Series Working Paper No. 4, (1999), available at http://ssrn.com/ abstract=200732; C. Mitchell, *Interpretation of Contracts, above n.* 17, 99.
[29] A. W. Katz, 'Form and Substance', above n. 7, 499; C. Mitchell, *Interpretation of Contracts*, above n. 17, 102.
[30] C. Sunstein, 'Must Formalism Be Defended', above n. 21, 642. See also L. Kaplow, 'Rules versus Standards: An Economic Analysis' (1992) 42 *Duke Law Journal* 557, 563 (arguing that the choice between rules and standards in legal regulation depends on the interplay of various factors that can only be verified empirically).
[31] C. Mitchell, *Interpretation of Contracts*, above n. 17, 101; A. W. Katz, 'Form and Substance', above n. 7, 520; C. Sunstein, 'Must Formalism Be Defended', above n. 21, 641-2; A. Schwartz and R. E. Scott, 'Redux', above n. 5, 964; A. W. Katz, 'Form and Substance', above n. 7, 497
[32] A. Schwartz and R. E. Scott, 'Redux', above n. 5, 938.
[33] C. Mitchell, *Interpretation of Contracts*, above n. 17, 105.

can be overridden by extrinsic evidence that the parties lacked any such intent (the 'soft' parol evidence rule).[34] Courts can also override the prima facie plain meaning of contractual terms, by considering contextual evidence that realigns the parties' written contract with its true meaning. Contextualism, thus, serves as a kind of judicial insurance policy that facilitates replacement or clarification of contract terms that, viewed in what the court believes to be the proper context, do not accurately reflect the parties' intentions.[35]

A variant of the contextualist theory argues that contextualism should be used primarily to determine the parties' choice of interpretive method. In line with the freedom of contract and party autonomy principles, courts faced with an interpretive dispute should first determine whether the parties opted for a more or less formal approach to interpreting their contract.[36] This inquiry, however, should be contextual. A broader range of evidence is preferable, in order to allow courts to determine with accuracy the parties' preferred interpretative method.[37]

In their pure forms, the two interpretive regimes are the extremes of a continuum of approaches. Pure textualism would mean that contracts are self-sufficient and words have acontextual, indisputable meanings that require no interpretation. Pure contextualism would mean the opposite – the interpreter would be free to discard the contract altogether and recover the parties' intentions from extrinsic evidence.[38] The preferable view is to regard textualism and contextualism as complements rather than opposites. This view shifts refocuses the debate on the relative weight that text and context should bear in the interpretation process, and on how far toward the formal or contextual ends of the spectrum the interpretation exercise should go. Interpretation thus becomes "a composite exercise, neither uncompromisingly literal, nor unswervingly purposive."[39]

3. Transaction costs and the optimal interpretive method

The goal of contract interpretation is to determine the parties' understanding of the content and meaning of the terms in their contract. Accuracy in interpretation is highly desirable, but it comes at a cost to all parties involved in the interpretive process. The economic view of contract interpretation emphasises the need to take into account the various ex ante and ex post transaction costs relevant to contract formation and interpretation, and the need to trade-off interpretive accuracy against these costs. Contracting parties often have more detailed and

[34] R. Gilson, C. Sabel and R.E. Scott, 'Text and Context', above n. 18, 36-7.
[35] R. E. Scott, 'Text versus Context: The Failure of the Unitary Law of Contract Interpretation' in F. H. Buckley (ed), *The American Illness: Essays on the Rule of Law* (New Haven, Connecticut: Yale University Press, 2013), 313; J. S. Kraus and R. E. Scott, 'Contract Design and the Structure of Contractual Intent' (2009) 84 *New York University Law Review* 1023, 1025.
[36] W. Woodward, 'Neoformalism', above n. 27, 977.
[37] C. Mitchell, *Interpretation of Contracts*, above n. 17, 104.
[38] J. Morgan, *Great Debates in Contract Law*, 2nd edn (Basingstoke: Palgrave Macmillan, 2015) 94.
[39] Lord Bingham, 'A New Thing under the Sun? The Interpretation of Contracts and the ICS Decision' (2008) 12 *Edinburgh Law Review* 374, 376. See also J. Steyn, 'The Intractable Problem of the Interpretation of Legal Texts' (2003) 25 *Sydney Law Review* 5, 8 (stating that interpretation "is not a science [but] an art. […] Educated intuition may play a larger role than the examination of niceties of textual analysis"); J. H. Wigmore, *Wigmore on Evidence*, 9th edn, (Boston: Little, Brown and Company, 1981) vol. 9, para 2461 ("The history of the law of interpretation is the history of a progress from a stiff and superstitious formalism to a flexible rationalism").

accurate information about the relevant costs and benefits, and thus have a comparative advantage over courts or legislators in choosing the interpretive rules that achieve an efficient trade-off.[40]

In general terms, where the costs of negotiating and writing a contract are low, parties can draft relatively complete contracts. Other things being equal, they will have a strong preference for formal contract interpretation, which is best suited to ensure the interpretation of these contracts in accordance with their express terms. When the ex ante costs of negotiating and drafting an agreement are high, due to factors such as the duration and complexity of the transaction or the parties' level of sophistication, complete contracts are more difficult to write. In these cases, the ex ante decision of how much to invest in filling contractual gaps is a key determinant of the interpretive regime that a given set of contracting parties is likely to prefer.[41]

Some contracting parties may prefer to incur low ex ante negotiating and drafting costs, and undertake the risk of high ex post enforcement costs, which are future and uncertain.[42] Such parties will rely on courts to fill in the contractual gaps through the process of contract interpretation. An efficient interpretation regime in this case would allow courts to use contextual evidence indicating the parties' understanding of their obligations under the contract.[43] When parties rely on courts to fill in the contractual gaps, the more expansive the courts' interpretative approach, the less specific the parties have to be in the written terms of their agreement.[44] Nevertheless, if litigation occurs and significant judicial gap filling is required, a contextual interpretation regime may increase significantly the overall transaction costs. This is because the relevant context has to be established drawing on a broader evidentiary base, which increases the costs of litigation and the possibility of court error.[45]

When the ex ante transaction costs are high, a contextual interpretive regime allows parties the flexibility to shift costs from the front-end of the contracting process to the back-end litigation stage.[46] The price for this flexibility is the risk of high ex post costs, such as litigation costs, court error or opportunism. In some instances, such as long term or repeat contracts, parties may decide that it is more efficient to incur the high ex ante costs and draft more complete contracts. Where parties voluntarily incur higher ex ante transaction costs, an interpretive regime that aims to maximise their expected joint surplus will aim to decrease the litigation-stage costs (the parties' own litigation costs, the cost of litigation to the judiciary, and judicial error costs). In other words, the more time the parties spend negotiating and

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[40] A. Schwartz and R. E. Scott, 'Redux', above n. 5, 944.

[41] A. B. Badawi, 'The Attributes of Transactions and Interpretive Preferences: The Limits and Borders of Contractual Formalism' Bepress Working Paper, (2007), available at http://works.bepress.com/adam.bbadawi/3 at 1-3. See also G. G. Triantis, 'The Efficiency of Vague Contract Terms: A Response to the Schwartz-Scott Theory of U.CC. Article 2' (2002) 62 *Louisiana Law Review* 1065 (discussing economic justifications of contractual gaps other than high ex ante transaction costs).

[42] A. Schwartz and R. E. Scott, 'Contract Theory' above n. 12, 585. For discussion of the reasons for incompleteness, see for example O. Hart and B. Holmstrom, 'The Theory of Contracts' in Truman Bewley (ed.), *Advances in Economic Theory*, (Cambridge, UK: Cambridge University Press, 1987) 71; O. Hart and J. Moore, 'Foundations of Incomplete Contracts' (1999) 66 *Review of Economic Studies* 115; and J. Tirole, 'Incomplete Contracts: Where Do We Stand?' (1999) 67 *Econometrica* 741.

[43] A.B. Badawi, 'Interpretive Preferences' above n. 41 at 1.

[44] C. Mitchell, *Interpretation of Contracts*, above n. 17, 109.

[45] Ibid., 110; Adrian Vermeule, "Three Strategies of Interpretation" (2005) 42 *San Diego Law Review* 607, 614.

[46] R. E. Scott, 'Text versus Context', above n. 35, 317.

drafting the contract, the more restrictive the court's approach to implied terms and interpretation should be.[47] A more formalist approach to interpretation is also desirable where courts are not better suited than parties to fill in contractual gaps. When the court's costs (the cost of determining the efficient implied term and the probability of error) are significantly higher than the parties' ex ante costs, an efficient regime will place the obligation to supply the missing term with the contractual parties, via penalty defaults that create incentives for further negotiations and information disclosure.[48] In other instances, where the contractual incompleteness could be an indication that the parties' negotiations have not reached the stage of actual agreement (such as lack of price or quantity), the court will refuse to fill in the gap. Otherwise, judicial interpolation would amount to writing the contract on behalf of the parties, rather than enforcing a pre-existing agreement.[49]

In yet other cases, contractual parties may decide to structure their transaction in ways that by-pass the high ex ante transaction costs. Techniques of avoiding or reducing such costs include agreeing to renegotiate potentially controversial matters, using catchall clauses such as best efforts or good faith as gap plugs, entering a series of shorter-term contracts that reduce the costs arising from imperfect foresight, or substituting vertical integration for contracting.[50] The selection of the optimal interpretive regime in these cases should be dynamic, in line with the structure that the parties have chosen for their transaction. As the remaining part of this section will show, there are a variety of reasons and factors that compel some parties to incur higher ex ante transaction costs, with a view to minimising the expected ex post litigation costs, while other parties leave broader gaps in their contracts that can be filled in ex post by courts.

3.1 Ex ante transaction costs and contract interpretation

As mentioned in the previous section, a simplified approach to understanding the parties' choice of interpretive regime links high ex ante transaction costs for the parties with a preference for contextualism, and low ex ante costs for the parties with formalism. This section discusses several scenarios where these correlations do not hold. In certain cases, rational economic actors prefer a formalist interpretation regime despite high ex ante transaction costs.

One instance of high ex ante costs is where the contract is negotiated and entered into by agents, especially where the principal is a company.[51] In this case, the principal may insist on greater formality and completeness of the documents in order to ensure that it will be bound only by the terms of the agreement, to the exclusion of negotiation statements, and to

[47] G. M. Cohen, 'Interpretation in Contract Law', above n. 2, 88.
[48] I. Ayres and R. Gertner, 'Filling Gaps in Incomplete Contracts', above n. 13, 87.
[49] R.A. Posner, 'Contract Interpretation', above n. 2, 1587-1588.
[50] G. M. Cohen, 'Interpretation in Contract Law', above n. 2, 80; R.A. Posner, 'Contract Interpretation', above n. 2, 1584; Oliver Hart and John Moore, "Agreeing Now to Agree Later: Contracts that Rule Out but do not Rule In" (2004) NBER Working Paper No. 10397, available at http://www.nber.org/papers/w10397; Jodi Kraus and Steven Walt, "In Defense of the Incorporation Strategy" in Jodi Kraus and Steven Walt, *eds*, *The Jurisprudential Foundations of Corporate and Commercial Law* (Cambridge: CUP, 2000) 193, 211-212. On vertical integration see Oliver E. Williamson, *The Economic Institutions of Capitalism* (New York: Free Press, 1985) 60-61; Hugh Collins, *Regulating Contracts* (Oxford: Oxford University Press, 1999) 163.
[51] C. Mitchell, *Interpretation of Contracts*, above n. 17, 113-114.

ensure that the contract can be used in the future by persons who had little or no involvement in its negotiation and drafting.[52] A principal may have incentives to invest in the ex ante drafting costs and select a formal interpretive regime in order to minimise the risk of loss resulting from agency costs. Agency costs arise due to the misalignment between the interests of the principal and those of the agent. Because agents are rational actors that seek to maximise their own utility, they have incentives to shirk or promote their own interest, while only satisfying the interests of the principal.[53] An insurance agent, for instance, may misrepresent the extent of the policy coverage or the applicant's insurability in order to earn a commission. A manager charged with supervising a supplier's obligations may shirk by failing to object to defective performance, thus jeopardising the principal's claims against the supplier.[54] In such contexts, principals can use formalism to disable agents from binding them in contracts that maximise the agent's private interests. For example, entire agreement clauses, anti-waiver clauses, or clauses negating reliance on statements during negotiations, can reduce the principal's loss from shirking or self-serving oral representations made by agents dealing with third parties.[55] A similar situation arises when third parties, such as banks or insurance companies, acquire an interest in the contract. Such third parties are more likely to demand detailed contractual provisions, and are more likely to seek the enforcement of the legal rights according to the terms of the agreement.[56] More generally, contracts whose value depends significantly on the participation of third parties will have higher value when interpreted under a relatively formalistic regime, other things being equal.[57]

Another instance where parties may incur higher ex ante costs is the case of new repeat contractors between whom trust has not yet been established. Such contractors are encouraged to incur higher initial transaction costs, due to the expectation of using their detailed contractual framework multiple times in the future, with the same or different contracting partners.[58] This is even more likely to happen when the contract is in an emerging field with high rates of failure, where parties enter an unusual venture with high litigation risks, or where parties have wide access to legal counselling.[59]

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[52] A. Berg, 'Thrashing through the Undergrowth' (2006) 122 *Law Quarterly Review* 354, 359.
[53] M. C. Jensen and W. H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305. In economics, 'satisficing' (a mix between satisfying and suffice) is used to denote the fact that agents pursue a goal until they reach a satisfactory level, rather than strive for the best result (see Chris Doucouliagos, 'A Note on the Evolution of Homo Economicus' (1994) 28 Journal of Economic Issues 877, 879).
[54] A. W. Katz, 'Form and Substance', above n. 7.
[55] Ibid. 533; see also E. A. Posner, 'The Parol Evidence Rule' above n. 4, 563-564; Kevin Davis, 'Licensing Lies: Merger Clauses, the Parol Evidence Rule and Pre-contractual Misrepresentations' (1999) 33 *Valparaiso University Law Review* 485, 534.
[56] C. Mitchell, *Interpretation of Contracts*, above n. 17, 119.
[57] A. W. Katz, 'Form and Substance', above n. 7, 534-535.
[58] C. Mitchell, *Interpretation of Contracts*, above n. 17, 110; D. Charny, 'Non-Legal Sanctions in Commercial Relationships' (1990) 104 *Harvard Law Review* 375, 436-437.
[59] L. Cunningham, 'Toward a Prudential and Credibility-Centered Parol Evidence Rule' (2000) 68 *University of Cincinnati Law Review* 269, 274; H. Beale and T. Dugdale, 'Contracts between Businessmen: Planning and use of Contractual Remedies' (1975) 2 *British Journal of Law and Society* 45, 48; A. W. Katz, 'Form and Substance', above n. 7, 536.

A similar scenario arises in high frequency transactions.[60] High frequency transactions create the potential for economies of scale.[61] Contractual parties capitalise on the opportunity to save transaction costs by choosing vertical integration of their businesses or by investing in drafting and negotiation costs. Contracts in high frequency transactions tend to have a higher degree of completeness for several reasons. First, rational parties will incur a large up-front cost in drafting the initial contract, with a view to saving ex ante costs in future similar transactions. As a transaction becomes more frequent, the marginal cost of drafting a governing contract will decrease. Second, as the transaction repeats, contracting parties have renewed opportunities to learn about the gaps in their contracts and how to plug them. Rational parties that are able to draft nearly complete contracts would prefer more formal types of interpretation. Because contracts contain fewer gaps, there is little need for extrinsic evidence.[62] If repeated over a significant period of time, high frequency transactions generate a body of industry norms and customs that parties could incorporate ex ante or rely on ex post to plug the gaps in their contracts.[63] In such cases, parties will lose their incentives to incur the high ex ante costs, and will prefer instead a contextualist interpretation that allows the norms and customs to be incorporated into their agreement. Not all industry norms, however, are economically efficient. Inefficient norms may arise and persist for a number of reasons, including information asymmetries, strategic behaviour, negative externalities, high renegotiation costs or status-quo bias.[64]

In contrast, parties to infrequent and highly complex relations prefer to rely on courts to complete their contract through ex post contextual interpretation. In such relations, a large number of low-probability contingencies that could affect the value of contractual performance exist, but the efficient responses to those contingencies cannot easily be specified in advance.[65] Mergers, for instance, are complex idiosyncratic transactions that involve high time constraints and uncertainty. The acute time pressure specific to merger transactions leaves parties to such transactions little scope for drafting nearly complete contracts. Even when time constraints are not severe, the particularities of each deal prevent parties from applying previously negotiated or standard clauses, to the same extent possible in high-certainty commodities transactions.[66] Construction contracts are another example of

[60] Frequency refers to the number of times a firm or individual carries out a particular type of transaction. See A.B. Badawi, 'Interpretive Preferences' above n. 41, 3.

[61] For examples of high-frequency transactions and the related interpretive regime see Bernstein's studies of diamond, grain, and cotton trades (L. Bernstein, 'Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms' (1996) 144 *University of Pennsylvania Law Review* 1765; L. Bernstein, 'The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study' (1999) 66 *University of Chicago Law Review* 710; L. Bernstein, 'Private Commercial Law in the Cotton Industry: Creating Co-operation through Rules, Norms and Institutions' (2001) 99 *Michigan Law Review* 1724).

[62] A.B. Badawi, 'Interpretive Preferences' above n. 41, 7- 8. See also S. J. Choi, M. Gulati & E. A. Posner, 'The Dynamics of Contract Evolution' (2013) 88 *New York University Law Review* 1.

[63] See R. D. Cooter, 'Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant' (1996) 144 *University of Pennsylvania Law Review* 1643, 1646.

[64] R. A. Posner, 'Let Us Never Blame a Contract Breaker' in O. Ben-Shahar and A. Porat, *eds, Fault in American Contract Law* (Cambridge University Press, 2010) 3, 17; E. A. Posner, 'Law, Economics, and Inefficient Norms' (1996) 144 *University of Pennsylvania Law Review* 1697, 1713-23.

[65] G. M. Cohen, 'Interpretation in Contract Law', above n. 2, 81; G. K. Hadfield 'Judicial Competence and the Interpretation of Incomplete Contracts' (1994) 23 *Journal of Legal Studies* 159, 165.

[66] A.B. Badawi, 'Interpretive Preferences' above n. 41, 40-42. For empirical evidence showing that parties to merger transactions prefer jurisdictions that have a contextualist approach to interpretation see G. Miller,

low frequency, high uncertainty deals that lead to a preference for contextual interpretation. Similar to mergers, construction agreements require bargaining over a high number of contingencies during a narrow time window. Rather than incurring the high ex ante negotiation and drafting costs, parties to such contracts often use standard form contracts supplied by the construction industry. These boilerplate agreements often mandate that any disputes be resolved through compulsory arbitration or other forms of alternative dispute resolution machinery, with an ensuing preference for contextualism.[67]

Uncertainty is another variable that affects the parties' drafting costs and their preference for a particular interpretive regime. Uncertainty in contractual relations arises due to the limits of the human capacity to receive, store, retrieve and process information without error, as well as due to the limitations of language to convey meaning.[68] These limits of the human cognition and language, referred to as bounded rationality,[69] affect the way in which economic agents structure their transactions. When the number and type of contingencies associated with a given transaction are unknown, it is impossible or prohibitively costly for parties to describe the substance of their agreement and to specify the contract terms to govern it. If parties envisage long term or high frequency relations and the predictive and linguistic uncertainties are acute, they may rely on internal organisational mechanisms such as vertical integration, to structure their relation and attenuate the risk of opportunism.[70] Alternatively, they may choose to leave gaps in contracts and rely on courts to fill the gaps through contextual interpretation.

Behavioural insights about contracting and contract as a social institution may also explain why some parties prefer to rely on a contextual interpretation regime, and shift high front-end transactions to the back-end enforcement stage of the contracting process. In relational contracts, trust and confidence between parties is essential to the creation and survival of the relationship.[71] In such contracts, a narrow focus on negotiating detailed terms may create an adversarial atmosphere by making the parties conscious of the risk of litigation and opportunism.[72] Incurring high ex ante transaction costs may cause parties to lose sight of the values necessary for the preservation of their relations, such as performance planning or the building of mutual trust.[73] Another behavioural reason for contractual gaps is that parties may rely on alternative governance mechanisms to regulate their behaviour, such as social norms or commercial reputation. These mechanisms are particularly suitable for commitments that have low stakes relative to litigation costs, or complex relations

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'Bargaining on the Red-eye: New Light on Contract Theory' (2008) New York University Law and Economics Working Papers, available at http://lsr.nellco.org/cgi/viewcontent.cgi?article=1135&context=nyu_lewp.

[67] A.B. Badawi, 'Interpretive Preferences' above n. 41, 46 (discussing standard form contracts provided by the American Association of Architects).

[68] O. E. Williamson, *Antitrust Economics: Mergers, Contracting, and Strategic Behaviour* (New York: Basil Blackwell, 1987) 74-78.

[69] H. A. Simon, 'Theories of Bounded Rationality' in C. B. McGuire and R. Radner (eds), *Decision and Organization* (Amsterdam: North-Holland, 1972) 161-76.

[70] A.B. Badawi, 'Interpretive Preferences' above n. 41, 10.

[71] D. Campbell, *ed*, *The Relational Theory of Contract: Selected Works of Ian Macneil* (London: Sweet and Maxwell, 2001) 154, 161.

[72] Charny, above n. 58, 407.

[73] C. Mitchell, *Interpretation of Contracts, above n.* 17, 111; W. Whitford, 'Relational Contracts and the New Formalism' (2004) *Wisconsin Law Review* 631, 637.

characterised by a high degree of mutual trust and good faith. The flexible and conciliatory nature of alternative governance mechanisms helps to preserve ongoing commercial relations. In these relations, leaving contractual gaps and relying on a contextual interpretive regime may provide stronger incentives for parties to adhere in good faith to the relevant norms, lest evidence to the contrary be admitted in a dispute.[74]

At the same time, there are arguments which favour of a more formalist approach to interpretation of relational contracts. In markets where a high level of mutual trust is necessary to preserve a contractual relation and to encourage cooperation with regard to performance of non-verifiable aspects of the contract, the prospect of extended litigation can undermine this trust and cooperation. Consequently, parties would prefer that disputes be kept short and straightforward through textualist adjudication.[75] This argument is supported by empirical research showing that parties who are members of trade associations and who thus rely on social norms as well as third party enforcement mechanisms, prefer formal interpretive rules and avoid contextualized jurisdictions.[76]

Another important current of thought in the law and economics literature on contract interpretation focuses on the link between the degree of sophistication of contractual parties and the optimal interpretive regime applicable to their contract. When both parties are legally unsophisticated, or are commercial entities that choose not to invest in ex ante contract design, and such parties do business in fields where legal norms blend with social and commercial norms, the optimal interpretation regime allows courts to determine the details of the contract by reference to a broader evidentiary base. An interpretive regime that prevents courts from accessing contextual information bearing on the parties' real relationship may result in an interpretation that is in opposition to the parties' actual intentions, and may frustrate these parties' efforts to govern their transactions efficiently.[77]

Contextualist interpretation is also desirable when legally unsophisticated individuals enter into written contracts with sophisticated parties who supply the written contract terms, such as consumer contracts. In these types of contract, the more sophisticated party has scope for abuse of its position by providing written contract terms that alter previous understandings.[78] Conversely, the passive parties are at risk of exploitation through adhesion to formal contract terms that do not reflect their real intentions.[79] The non-drafting parties

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[74] C. Mitchell, *Interpretation of Contracts*, above n. 17, 119-120; R.A. Posner, 'Contract Interpretation', above n. 2 at 1584; G. M. Cohen, 'Interpretation in Contract Law', above n. 2, 81-82; D. Charny, 'Non-Legal Sanctions' above n. 58, 408-409; A. Badawi, 'Interpretive Preferences and the Limits of the New Formalism' (2009) 6 *Berkeley Business Law Journal* 1, 34.

[75] A. W. Katz, 'Form and Substance', above n. 7, 525; See, e.g., L. Bernstein, 'Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry' (1992) 21 *Journal of Legal Studies* 115, 119-130 (describing relations of trust and dispute resolution mechanisms in the diamond market).

[76] A. Schwartz and R. E. Scott, 'Redux', above n. 5, 955.

[77] R. Gilson, C. Sabel and R.E. Scott, 'Text and Context', above n. 18, 27. For a discussion of the scholarship supporting this view, see S. J. Burton, 'A Lesson on Some Limits of Economic Analysis: Schwartz and Scott on Contract Interpretation' (2013) 88 *Indiana Law Journal* 339; S. J. Bayern, 'Rational Ignorance, Rational Closed-Mindedness, and Modern Economic Formalism in Contract Law' (2009) 97 *California Law Review* 943; J. W. Bowers, 'Murphy's Law and the Elementary Theory of Contract Interpretation: A Response to Schwartz and Scott' (2005) 57 *Rutgers Law Review* 587.

[78] A. W. Katz, 'Your Terms or Mine? The Duty to Read the Fine Print in Contracts' (1990) 21 *Rand Journal of Economics* 518, 533.

[79] R. Gilson, C. Sabel and R.E. Scott, 'Text and Context', above n. 18, 27.

will generally not have the economic incentives or the ability to examine the standard terms with the care required to reveal the self-serving provisions. These parties will either enter into contracts that do not fully reflect their intentions, or will assume that the self-serving terms have been included and discount the price they are willing to pay accordingly.[80] The role of lawyers in drafting such contracts is another factor that unsettles the balance of bargaining power between parties. Most standard commercial contracts are drafted by lawyers, whose compensation structure provides them with incentives to draft terms that are inefficiently favourable to their corporate client. Transactional lawyers are more likely to be punished for omitting a term that could lead in some remote contingency to a loss for their client firm, than they are to be rewarded for the time saved by the omission of unnecessary terms. Consequently, lawyers will tend to overdraft the contract, and include terms that place on the customer risks and duties that can be cheaply borne by the company.[81]

The inequality of bargaining power and expertise that characterise these contracts contradict the assumptions of individualised contract design that are associated with the textualist argument. Formal interpretive rules that exclude certain categories of extrinsic evidence would deprive courts of potentially relevant information thus distorting their ability to determine the real terms of the agreement.[82] Allowing the courts to examine ex post the context of these transactions helps them to identify any disparity between the terms of the bargain and the written contract terms, thereby protecting unsophisticated parties from hidden forms of exploitation.[83] Even when abuse of barraging power is not a concern, a contextualist regime of interpretation could be justified by the notion that both individual consumers and commercially sophisticated firms would prefer courts to take advantage of hindsight in assisting them to achieve their contractual objectives.[84] Moreover, an interpretive regime that de-emphasises the text of the agreement in favour of evidence that is harder to manipulate, such as market expectations, could serve as a bonding cost that allows the dominant party to commit to abstaining from such self-serving behaviour.[85]

While these concerns are valid reasons for applying a contextualist interpretation regime to consumer contracts, they are less persuasive for negotiated contracts between commercially sophisticated firms.[86] The prototypical sophisticated parties are profit-maximising risk-neutral firms, which have access to legal counsel.[87] Sophisticated risk-neutral firms prefer to limit their drafting and enforcement costs to the level where a court has enough information to make an accurate interpretation of the contract on average. Although a high degree of interpretive accuracy is desirable, judicial accuracy comes at a cost to contractual parties. When parties are sophisticated and risk-neutral, they have no incentives to

[80] A. W. Katz, 'Form and Substance', above n. 7, 531.
[81] Ibid., 533.
[82] R. E. Scott, Scott, 'Text versus Context', above n. 35, 317.
[83] R. Gilson, C. Sabel and R.E. Scott, 'Text and Context', above n. 18, 38.
[84] R. E. Scott, Scott, 'Text versus Context', above n. 35, 314.
[85] A. W. Katz, 'Form and Substance', *above n.* 7, 531.
[86] A. Schwartz and R. E. Scott, 'Contract Theory' above n. 12, 541.
[87] R. Gilson, C. Sabel and R.E. Scott, 'Text and Context', above n. 18, 26. Sophisticated firms include corporations with five or more employees, limited partnerships, and professional partnerships such as law and accounting firms (A. Schwartz and R. E. Scott, 'Contract Theory' above n. 12, 544-545). See also S. Bayern, 'Contract Meta-Interpretation', above n. 14, 1104-1118 (rejecting Schwartz and Scott's assumption that all sophisticated firms are risk-neutral profit maximisers).

expend further resources to shrink the variance around the correct mean.[88] Under a textual interpretation regime, a hard parol evidence rule coupled with a plain meaning rule allows such parties to balance their ex ante drafting costs and ex post enforcement costs in a manner that reflects their preference for interpretation accuracy on average. Parties are able to retain control over the relevant context via a merger clause that integrates their entire understanding, including relevant context, into the written contract, and excludes particular categories of evidence, such as the parties' practice under prior contracts between them or their course of performance.[89] Thus, legally sophisticated parties are likely to reject a court's efforts to supplement or circumvent their original design by its own contextual investigation.[90] A contextual meaning rule would limit the parties' freedom to narrow the interpretive context, even when doing so is necessary to maximise the expected value of their contract.[91]

3.2 Contract interpretation and ex post transaction costs: opportunism and judicial error

Contract interpretation is often regarded as a means for courts to reduce the problem of opportunism in contractual relations. Economic opportunism means "self-interest seeking with guile."[92] Opportunistic behaviour results in an unbargained-for redistribution of wealth that runs counter to the parties' agreement, or the relevant contractual or moral norms.[93]

The threat of opportunism induces parties to spend additional resources to protect themselves against this eventuality, thus raising their overall transaction costs.[94] In many instances, ex ante contractual protection is impossible or prohibitively costly. In complex contracts, for instance, the parties have to anticipate not only potential changes in the relevant economic variables but also the risk of opportunistic behaviour by the other party in every possible contingency. Even when contractual protection is possible, opportunism can be difficult to detect when it has the appearance of legitimate conduct.[95] When the risk of opportunism is high and the costs of preventing or detecting it are prohibitive, contractual relations may fail to form. Courts can reduce transaction costs and prevent market failures by adopting an interpretive regime that minimises the risk of opportunism. No single interpretive regime, however, is able to achieve this goal across all types of contract and all forms of opportunism. Contextualism and textualism have their relative advantages in deterring

[88] A. Schwartz and R. E. Scott, 'Redux', above n. 5, 931-933. For empirical evidence supporting the view that sophisticated parties would prefer a regime that excludes contextual evidence, see G. Miller, 'Bargaining on the Red-eye', above n. 66.
[89] A. Schwartz and R. E. Scott, 'Redux', above n. 5, 584-588; R. Gilson, C. Sabel and R.E. Scott, 'Text and Context', above n. 18, 316; See also R. E. Scott and G. G. Triantis, 'Anticipating Litigation in Contract Design' (2006) 115 *Yale Law Journal* 814.
[90] R. Gilson, C. Sabel and R.E. Scott, 'Text and Context', above n. 18, 319.
[91] A. Schwartz and R. E. Scott, 'Redux', above n. 5, 963.
[92] O. E. Williamson, *The Economic Institutions of Capitalism* (New York: Free Press, 1985) 47.
[93] G. M. Cohen, 'The Negligence-Opportunism Tradeoff in Contract Law' (1992) 20 *Hofstra Law Review* 941, 957; T. J. Muris, 'Opportunistic Behavior and the Law of Contracts' (1981) 65 *Minnesota Law Review* 521, 523.
[94] T. J. Muris, 'Opportunistic Behavior', above n. 93, 524.
[95] Ibid. 525.

opportunism, depending on whether this is a more significant problem ex ante or ex post, or whether it is more likely to arise in relation to the contractual text or context.[96]

Opportunism can arise ex ante, during the negotiation and drafting stage. For instance, a party may be tempted to fill the negotiating record with self-serving proposals and offers, in the hope that it can later convince a court applying a contextual interpretation that these statements were in fact part of the contract. The risk of such opportunism explains why, even in a contextual regime, courts are more sceptical of evidence that can be easily manipulated, such as pre-contractual negotiations,[97] As such, here, the courts will protect contracting parties from 'unfair surprise' and their reasonable reliance interests as well those whose rights, duties and liabilities may be affected by the behaviour of opportunist parties.[98] In a textualist regime, an opportunist party may be tempted to sneak self-serving terms into the text of the contract, with a view to invoking them subsequently at the interpretation stage.[99] The contextual regime is arguably more conducive to ex ante opportunism, given the range of evidence that it is possible to adduce.[100]

More often, opportunism arises ex post. When contract terms are susceptible to several meanings, some reflecting the original bargain and others deviating from it in a way that serves the interests of one party, this party may be able to exploit this ambiguity and claim that his performance is compliant or the other party is in breach. Alternatively, an opportunistic party may use court interpretation to his advantage by seeking to have a term interpreted according to its common or plain meaning, when that meaning fails to reflect the original bargain.[101] Ex post opportunism can also arise from a contractual gap. When parties have not formulated an intention with regard to a particular contingency, due to lack of foresight or to deliberate use of vague or broad terms, a party may use the relevant context to seek an unbargained for advantage. Because incentives to act opportunistically can arise under both textualism and contextualism, the aim of preventing or reducing this form of abuse cannot be taken to call for a specific interpretive approach.[102]

The holdup problem is another example of ex post opportunism. When sellers must make private sunk-cost investments in order to produce goods or services for particular buyers, they expose themselves to the risk of ex post opportunistic renegotiation or termination of the relationship by the buyer. When the sunk costs are low, the risk of

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[96] A. W. Katz, 'Form and Substance', above n. 7, 531; G. M. Cohen, 'Interpretation in Contract Law', above n. 2, 92-3.

[97] See E. A. Posner, 'The Parol Evidence Rule' above n. 4, 564-5 (arguing that the risk of opportunism is a possible reason in favour of a formalistic parol evidence rule); G. M. Cohen, 'Interpretation in Contract Law', above n. 2, 92.

[98] *Report on Interpretation in Private Law* (Scot Law Com No. 160) (1997) para. 2.6 at pp.9-10.

[99] A. W. Katz, 'Form and Substance', above n. 7, 531; A. Schwartz and R. E. Scott, 'Contract Theory' above n. 12, 585-586.

[100] C. Mitchell, *Interpretation of Contracts*, above n. 17, 113.

[101] J. P. Kostritsky, 'Plain Meaning vs. Broad Interpretation: How the Risk of Opportunism Defeats a Unitary Default Rule for Interpretation' (2008) 96 *Kentucky Law Journal* 43, 49; G. M. Cohen, 'Interpretation in Contract Law', above n. 2, 91.

[102] J. P. Kostritsky, 'Plain Meaning', above n. 101, 48-49; C. Mitchell, *Interpretation of Contracts*, above n. 17, 113. See also D. Campbell, 'The Relational Constitution of Contract and the Limits of 'Economics': Kenneth Arrow on the Social Background of Markets' in S. Deakin and J. Michie (eds), *Contracts, Co-operation and Competition: Studies in Economics, Management and Law* (Oxford: Oxford University Press, 1997) 307, 312-313.

opportunism is low. In a thick market for substitute performance, a seller can recoup the sunk costs simply by switching to a new contracting partner.[103] When asset specificity is high, rational sellers tend to underinvest in the sunk costs, for fear of losing some or all of their value in an ex post holdup.[104] In such cases, a high degree of interpretive accuracy is needed to induce sellers to invest efficiently. To the degree that a contextual regime is able to reduce the difference between the interpretive outcomes ex post and the parties' agreement at the time when the sunk costs are made, contextualism could help minimise the holdup problem.[105] When the parties are able to negotiate a contractual solution that decreases the risk of holdup, such as drafting a complex contract or giving the seller control over the quantity of goods to be delivered, they will have less need for interpretive accuracy and will prefer a more formalist regime.[106]

Chiselling behaviour is another instance of ex post opportunistic deviation from an agreement. Chiselling occurs when a party supplies less than the performance required under the contract, but claims that the performance is compliant and entitles him to the full price.[107] In one view, parties have fewer incentives to chisel in a contextualist regime.[108] A party's incentive to chisel is directly proportional to the likelihood that his chiselling behaviour will be protected by an erroneous contract interpretation.[109] When a party is willing to chisel and gamble on an erroneous (but favourable to him) interpretation from the court, a rule that allows the maximal evidentiary base counteracts such incentives by increasing interpretive accuracy and shrinking the variance of the court's expected result.[110] Nonetheless, there are arguments which favour literalism as a means to deter chiselling and opportunistic litigation. The chiselling party only benefits when the court erroneously finds that the contract require only the performance that he tendered. He will stand to lose, however, if the court correctly finds that the contract required a conforming performance, or if it erroneously finds that the contract requires a greater performance than what the parties actually agreed on. In other words, the chiselling party benefits from errors on the low side, but stands to lose both from a correct interpretation and from errors on the high side. Since the textualist regime relies on less evidence, the variance of the court's expected result is higher, which means a higher probability that the chiselling party will lose. In this view, parties would select a textualist interpretation regime in order to reduce the incentives to chisel. .[111]

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[103] C. Goetz and R. E. Scott, 'The Limits of Expanded Choice', above n. 11, 262; G. M. Cohen, 'Interpretation in Contract Law', above n. 2, 92. For an in-depth discussion of sunk costs and asset specificity, see D. Baird and E. Morrison, 'Serial Entrepreneurs and Small Business Bankruptcies' (2005) 105 *Columbia Law Review* 2310.
[104] A. W. Katz, 'Form and Substance', above n. 7, 529.
[105] Ibid., 530.
[106] E. Maskin and J. Tirole, 'Unforeseen Contingencies and Incomplete Contracts' (1999) 66 *The Review of Economic Studies* 83; O. Hart and J. Moore, 'Contracts as Reference Points' (2008) 123 *The Quarterly Journal of Economics* 1; G. Noldeke and K. Schmidt, 'Option Contracts and Renegotiation: A Solution to the Hold-up Problem' (1995) 26 *The Rand Journal of Economics* 163; A. W. Katz, 'Form and Substance', above n. 7, 530.
[107] A. Schwartz and R. E. Scott, 'Redux', above n. 5, 948.
[108] S. Bayern, 'Rational Ignorance', above n.77, 943.
[109]J. W. Bowers, 'Murphy's Law and the Elementary Theory of Contract Interpretation: A Response to Schwartz and Scott' (2005) 57 *Rutgers Law Review* 587, 601.
[110] S. Bayern, 'Rational Ignorance', above n.77, 970.
[111] For a numerical example illustratng the effect of textualism on chiselling incentives see A. Schwartz and R. E. Scott, 'Redux', above n. 5, 949-951.

In conclusion, no single optimal interpretation regime that is able to address all forms of opportunism can be identified. Contextualism has the advantage of a higher likelihood that the interpretive result corresponds to the parties' real bargain. Its downside is that parties are tempted to invest substantial resources in manipulating the context or engaging in opportunist litigation in order to maximise the chance of obtaining an unbargained-for favourable outcome. Formalism, in contrast, limits the scope for ex post interpretive disputes, thus reducing the marginal productivity of opportunist litigation and decreasing this component of transaction costs.[112]

The possibility of the court erring in its interpretation of a contract is another ex post contingency that parties have to take into account under both textualism and contextualism. When courts are accurate and competent, the parties' litigation costs are minimised because they have fewer incentives to raise spurious interpretive issues, and because the judges need less help from the lawyers to reach the correct result. This would encourage parties to write more contracts, which in turn might lead to an increase in the litigation rate. Litigation might increase also because parties might prefer the highly competent judicial dispute resolution to arbitration. This would result in an increase in the governmental costs with the judiciary, but such costs would presumably be offset by the social benefits of correct interpretive outcomes and additional contracts.[113] Real courts, however, are prone to errors. A judicial error occurs when the outcome at the litigation stage is different than what the parties would have agreed to at the formation stage. This may occur, for instance, where the court interprets a contract term in a way that runs counter to the parties' real intentions. When the court has to fill in a contractual gap, under both contextual and formal interpretation techniques, it may have to make a decision on a matter that the parties had not considered and over which they had not expressed any intention. This makes it difficult to determine whether a judicial error occurred or not.[114]

Determining the optimal interpretation regime applicable to a particular transaction involves determining which methodology has the lowest rate of court error, and at what cost.[115] One way of minimising the decision and error costs is requiring courts to ascribe to contractual terms their objective meaning, without investigating what the parties would have chosen had they made explicit provision on the point.[116] Taking into account the principle of goal-neutrality in interpretation, however, this solution is unlikely to yield optimal results. The better view is that the question of which regime is less prone to judicial error cannot be answered in the abstract. Courts and parties should have the option of selecting a more textual or contextual approach to interpretation, depending on the circumstances of each case. In a textualist regime, when transaction costs are low, parties can minimise the risk of court error by drafting more detailed and complete contract terms.

Textualist courts will interpret a detailed contract more accurately than contextualist courts, which will sometimes erroneously rely on contextual evidence in addition to the

[112] A. W. Katz, 'Form and Substance', above n. 7, 531.
[113] R.A. Posner, 'Contract Interpretation', above n. 2, 1592.
[114] C. Mitchell, *Interpretation of Contracts*, above n. 17, 114.
[115] G. M. Cohen, 'Interpretation in Contract Law', above n. 2, 97.
[116] C. Sunstein 'Must Formalism Be Defended', above n. 21, 648; E. A. Posner, 'A Theory of Contract Law under Conditions of Radical Judicial Error' (2000) 94 *Northwestern University Law Review* 749.

written text.[117] At the same time, low drafting costs do not necessarily eliminate the risk of interpretive error. The more detailed the contracts are, the higher the risk that such contracts contain ambiguous or contradictory terms. Textualist courts that must interpret longer and more complex contracts are more likely to misconstrue a term to cover a particular contingency the parties did not intend to cover.[118]

When ex ante costs are high, contextualism has the advantage of decreasing these costs by allowing courts to fill in the contractual gaps. The decreasing costs argument in favour of the contextual approach only holds if the parties trust that the interpretive result reflects what they would have bargained for ex ante.[119] Contextualism increases the risk of judicial error by increasing the amount of information that is relevant to the interpretation exercise.[120] Courts may err in determining the parties' reasonable expectations or by adopting an inaccurate view of what the parties consider an unreasonable or absurd result.[121]

Parties that doubt a court's ability to provide a correct interpretation may prefer the occasional incorrect or absurd result associated with textualism to a regime where ineffectual judges are empowered to search for purpose or absurdity. The broad interpretive powers that courts have in the latter case present a risk of error or variance of decision that is more harmful than the risk of an absurd result arising in the former case.[122] The costs of using an incompetent or corrupt court to determine the parties' intentions or to find the most efficient resolution of the interpretive question might be prohibitive. When these ex ante costs are lower than the expected savings resulting from fewer court errors, textualism becomes the efficient regime.[123] When the costs are higher than the expected benefits, the parties may be forced to over-invest in negotiation, drafting and monitoring costs, or may avoid the courts altogether by choosing arbitration or vertical integration.[124]

From the courts' perspective, conventional wisdom suggests that limited judicial discretion is preferable when courts are unsure about their analytical abilities. A court that feels unsure of how to identify and process the information necessary to retrieve the parties' intention may prefer a textualist regime composed mainly of straightforward bright line rules. Courts that feel more confident in their abilities, in contrast, may prefer a more cautious and nuanced approach to interpretation and liability.[125] Nevertheless, the high risk of error associated with ineffectual or corrupt courts does not necessarily create a preference for a textualist method that limits the court's interpretive role. Some parties may respond to this risk by simply adjusting the price of the contract to reflect their estimated likelihood of court error.[126] Moreover, arguments exist to support the rather counter-intuitive view that, when the

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[117] R.A. Posner, 'Contract Interpretation', above n. 2, 545-6.
[118] G. M. Cohen, 'Interpretation in Contract Law', above n. 2, 95.
[119] C. Mitchell, *Interpretation of Contracts,* above n. 17, 109; D. Charny, 'Non-Legal Sanctions', above n. 58, 405.
[120] See J. Gava and J. Grene, 'Do We need a Hybrid Law of Contract? Why Hugh Collins Is Wrong and Why It Matters' (2004) 63 *Cambridge Law Journal* 605, 616-20.
[121] C. Mitchell, *Interpretation of Contracts,* above n. 17, 115-17.
[122] F. Shauer, *Playing by the Rules: A Philosophical Examination of Rule-Based Decision-Making in Law and in Life* (Oxford: Oxford Univerisyt Press, 1991) 214.
[123] R.A. Posner, 'Contract Interpretation', above n. 2, 542-544.
[124] Ibid., 1539; G. M. Cohen, 'Interpretation in Contract Law', above n. 2, 94.
[125] See R. Posner, *The Problems of Jurisprudence* (Harvard University Press, 1990) 94, 319.
[126] G. M. Cohen, 'Interpretation in Contract Law', above n. 2, 94.

court effectiveness is low, a contextual regime that allows for the use of standards rather than bright line rules of interpretation is preferable.[127] Bright line rules require courts to determine whether a party's performance falls short of a fixed level, whereas standards instruct the court to attempt to determine whether the performance meets a certain minimum value, given the information available to the court.[128] When courts have a low degree of competence, a contextual regime may require them to devote more effort to understanding the contextual details necessary to determine if performance is compliant. Contractual parties, in turn, are likely to realise that their marginal liability can be reduced through increases in cooperative efforts that the court can observe. Thus, parties are encouraged to take steps in the direction of optimal behaviour. In contrast, when low-competence courts apply bright line rules, parties are likely either to ignore the rule and make no adjustments in behaviour, or to adopt the safe harbours chosen by the courts, which may deviate significantly from an optimal outcome for different types of defendants.[129]

A similar problem arises with regard to a court's determination of the interpretive methodology that the parties chose, a process sometimes referred as meta-interpretation.[130] In one view, the risk of error in meta-interpretation is reduced when the courts use all available information to determine the agreement that the parties had, or the agreement that reasonable parties would have had, about their preferred mode of interpretation. As with the interpretation of the substance of a contract, the diversity and complexity of contractual relations makes it difficult to derive from theoretical principles an optimal meta-interpretive regime. The appropriate resolution of meta-interpretive questions should parallel the resolution of interpretive questions, and relevant features of context should be taken into account when they are necessary to determine the parties' preferences in individual cases.[131] When contracting parties formulate an express preference for textualism through, for example, merger clauses/entire agreement clauses, a textual meta-interpretation that lowers the parties' costs of accurately expressing their methodological intentions is preferable, from an economic perspective.[132] But, once again, if courts make errors in determining the parties' intentions, they may also err in determining their methodological preference and choose contextualism too often.[133] In some cases, error in meta-interpretation may be irrelevant. Contractual parties may be indifferent to the court's error in identifying their preferred interpretation method, provided that the court is likely to reach a correct substantive interpretation outcome using the wrong interpretive methodology.[134]

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[127] G. K. Hadfield 'Judicial Competence and the Interpretation of Incomplete Contracts' (1994) 23 *Journal of Legal Studies* 159.
[128] Ibid. 175-6.
[129] Ibid. 180-3. See also A. Schwartz and R. E. Scott 'The Common Law of Contract and the Default Rule Project' (2016) 102 *Virginia Law Review* 1523 (discussing the use of rules and standards by courts in the filling of contracual gaps).
[130] S. Bayern, 'Contract Meta-Interpretation', above n. 14, 1102.
[131] Ibid., 1145.
[132] G. M. Cohen, 'Interpretation in Contract Law', above n. 2, 96.
[133] E. A. Posner, 'The Parol Evidence Rule' above n. 4, 547-8 and 570-1.
[134] G. M. Cohen, 'Interpretation in Contract Law', above n. 2, 96.

4. Conclusion

Economic agents enter contracts with a view to maximise the joint surplus. A key purpose of every contract is to describe the rights and obligations that each party undertakes in the pursuit of the joint welfare maximisation aim. Contracts typically do not provide for all variables and contingencies that are of potential relevance to performance. Incompleteness is a central, rather than tangential, feature of commercial contracts and a key theme in the economic literature on contract interpretation. When performance unfolds over time, parties cannot foresee and bargain ex ante over every relevant contingency, due to high transaction costs or bounded rationality. Even under low transaction costs and perfect rationality, parties may choose to leave potentially contentious points for future negotiations, to withhold information for strategic purposes, or to delegate contractual completion to courts, should a particular contingency arise.

When contracts are incomplete and their terms are ambiguous or contradictory, interpretation is necessary in order to ascertain the parties' intentions at the time of contract formation. Disputes about the existence or meaning of terms are bound to arise even in the most carefully drafted contracts, especially when a party's liability is at stake. The interpretive process is expected to be goal-neutral, in the sense of facilitating the achievement of parties' goals. The principle of court neutrality in determining the parties' intentions implies that a high degree of accuracy in interpretation is desirable. Contract writing and litigation are costly, however, and an optimal interpretive method must discount the benefit of accuracy with contract-writing and adjudication costs. A long-standing controversy exists over which interpretive strategy is more effective in approximating the parties' intentions.

Textualism has the advantage of predictability, celerity and low litigation costs, at the expense of interpretive accuracy and ex ante transaction costs. Contextualism saves bargaining and drafting costs and maximises accuracy, but comes with uncertainty and high litigation costs. An emerging approach to the problem of identifying the optimal interpretive regime places the choice of interpretive method with contractual parties rather than courts or legislators. In this view, textualism is not opposed to contextualism. The question is not one of relative superiority, but one of efficient choice. Contracting parties are in a better position to make an efficient trade-off between their costs and the benefits of increased accuracy in interpretation. The efficient choice between formal and substantive interpretive regimes depends on multiple variables, including the parties' degree of sophistication, the length and complexity of their relation, and the need to prevent opportunism or judicial error.