

# 4400

## IMPLIED TERMS AND INTERPRETATION IN CONTRACT LAW

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### Abstract

This chapter examines the economic arguments for textualism and contextualism, the two primary methodologies used by courts to determine the intentions of contracting parties with respect to their performance obligations. Textualism, which is rooted in the idea of complete contracting, calls for a more restrictive approach to implied terms and interpretation than contextualism, which is rooted in the idea of incomplete contracts. The primary conclusions are that, as in other areas of contract law, the choice between the two interpretive methodologies depends on the transaction costs of drafting, the relative likelihood of court error, and the risks of opportunistic behavior. Neither methodology dominates so much that it should be uniformly employed, which is consistent with how courts actually behave.

*JEL classification:* K12

*Keywords:* Contracts, Completeness, Interpretation, Implied Terms, Opportunism, Contextualism, Textualism

### 1. Introduction

Questions of how courts interpret, and should interpret, contract terms and when courts imply, and should imply, terms to which the contracting parties have not explicitly agreed, loom large in contract disputes and in the legal literature on contract law. Law and economics scholars, however, have written far more extensively on other topics in contract law than on these questions. For example, Judge Posner's treatise has no section specifically discussing interpretation or implied terms, and discusses contractual good faith in only two paragraphs (Richard Posner, 1998, pp. 103, 126). Other leading textbooks also have no discussion of interpretation or implied terms. One possible explanation for this discrepancy is that there is little need for research specifically on interpretation and implied terms because much of the economic analysis of other areas of contract law carries over straightforwardly to these

questions. An alternative explanation is that economic analysis has less to say about interpretation methods than it does about other questions in contract law. This article, which will summarize and expand on the literature that does exist, aims to demonstrate that economic analysis has a good deal to say about interpretation questions, but the issues are complex and there are many fruitful avenues for further research.

The argument that there is no real need for a separate economic analysis of interpretation and implied terms stems from the fact that the delineation of the topic is based on legal rather than economic considerations. In contract law, interpretation usually refers to problems arising from express contract terms that are reasonably susceptible of more than one meaning. Implied terms are those that are added to, or place limits on, expressly stated terms. The two are closely related, yet not identical. For example, if a contract contains a 'best efforts' clause, determining what that clause requires is a question of interpretation; if the contract contains no such clause, courts may have to decide whether to imply a best efforts obligation, and if they do, they have to determine the content of that obligation. On the other hand, some questions of interpretation do not involve questions of implication, for example, a dispute over the meaning of the word 'chicken'.

In some sense, all contract disputes involve questions of interpretation and implied terms. For example, *force majeure* clauses - usually discussed in the context of the (implied) impossibility defense - present questions of interpretation, and most contract formation, excuse, and damage rules are 'implied terms'. But contract law has generally used the labels 'interpretation' and 'implied terms' more narrowly, to refer to questions of contract performance, rather than questions of formation, excuse, defense, or remedy. That is, the legal issue addressed by these doctrines is whether one or more parties have performed as the contract requires, or have breached. Thus, I will assume for purposes of this discussion that the parties have made an enforceable contract, there are no changed circumstances or 'mistakes' sufficient to give rise to an excuse claim, the applicable remedies in the event of breach are accepted, and there are no third-party effects. How do courts decide - and how should they decide - what the performance obligations are and whether the parties have met them?

## 2. Complete or Incomplete Contracts

Economic analyses of contract law have tended to start with the idealized concept of a 'complete' contract, though this term has perhaps engendered more confusion than clarity. Traditionally, a complete contract has referred to one that provides a complete description of a set of possible contingencies and

explicit contract terms dictating a performance response for each of these contingencies (Al-Najjar, 1995; Hart and Moore, 1988). Contingencies include changes in 'exogenous' economic variables, such as a production cost increase. But they also include 'endogenous' behavioral responses, such as falsely claiming a cost increase or seeking refuge from a now-disadvantageous bargain behind a contract term intended to serve a different purpose. Economic analyses generally conclude that if a contract is complete, there is no beneficial role for a court other than to enforce the contract according to its terms; that is, incompleteness is a necessary, though not sufficient, condition for an active court role in interpretation and implied terms.

But because no real-world contracts are fully complete in this sense, the concept of completeness does not get us very far. The concept can be rescued in one of three ways. One way is to view completeness as a useful benchmark, similar to perfect competition. Just as some markets are close enough to being perfectly competitive that the perfect competition model is a useful predictor, so some contracts may be complete enough that no reasonable interpretation or implied term questions arise. The law refers to these contracts as 'integrated'. But tying completeness to integration simply reduces to a tautology the statement that a complete contract obviates the need for interpretation or implied terms. The question is how do courts know when a contract is complete in this sense.

One way courts can know a contract is complete is if the parties tell them. Thus, a second way to rescue completeness is to recognize that contracting parties can make a contract complete by using general 'catchall' clauses that state what happens in all unspecified states of the world (Hermalin and Katz, 1993, p. 236; Hadfield, 1994, p. 160, n.5). For example, a catchall clause might state: 'The price term will be x, and will apply regardless of any change in circumstances or conduct by either party'. Alternatively, the parties could state their general desire not to have courts interpret or imply terms. But although contracting parties often use general clauses such as merger clauses, which direct a court to apply a particular interpretive methodology (that is, do not look beyond the writing), they do not seem to use catchall clauses that are broad enough to make contracts complete. Of course, clauses that are not stated as catchalls could be - and sometimes are - interpreted that way, but, to lawyers at least, if not economists, that act of interpretation then requires justification (Hadfield, 1994, p. 160). Even clauses that are stated as catchalls might require interpretation (Charny, 1991). Moreover, contracting parties often use contracting clauses that are the exact opposites of completeness catchalls: general clauses such as 'good faith' or 'best efforts' clauses signal contracting incompleteness, as opposed to completeness (Hadfield, 1994, p. 163).

A third way to rescue completeness, more common in formal economic modeling, is to tie the concept of completeness to the efficient use of available

information. A complete contract is one that makes full use of the private information available to the contracting parties (Hermalin and Katz, 1993, p. 235). The point of this definition is to make clear that parties can write efficient contracts that do not expressly specify the response to every contingency, yet obviate the need for court intervention (Hermalin and Katz, 1993, p. 242). But the fact that parties may in a simplified model be *able* to write 'economically complete' contracts does not answer the question of whether in a given legal dispute they have *in fact* written one. And the ability of private parties to write economically complete contracts in the real world is unclear. We do not seem to see, for example, contracts of the type described by Hermalin and Katz, in which the contract leaves the quantity and price unspecified, then after some period one party names the price and the other names the quantity. Perhaps the costs of writing these contracts (including the costs of strategic circumvention) are too high. Perhaps the current enforcement regime interferes with, or discourages, the parties, writing of such contracts, though this seems unlikely.

It seems fair to say, however, that many if not most contracts are incomplete, or at least the question of their completeness is itself a legitimate question for judicial interpretation. The incompleteness may be intended by both parties, which creates so-called 'relational contracts' (Goetz and Scott, 1981), or 'fiduciary contracts' (Easterbrook and Fischel, 1983, p. 438). It may result from unintended 'formulation error' which occurs when, as a result of defective contractual instructions, the occurrence of some contingency produces surprising consequences (Goetz and Scott, 1985, p. 267, n. 11). It may result from strategic withholding of information by one party. Or incompleteness may result from court error. Whether a contract that the parties think is complete, but is misinterpreted by a court, should in fact be viewed as an 'incomplete' contract depends on how completeness is defined. If completeness is defined with reference to the obviation of interpretive questions, the definition must assume that completeness means that a contract's terms are 'unambiguous', that is, the contract terms represent a confluence of the parties' intentions and the court's ability to interpret those intentions correctly (unless the contract is somehow self-enforcing).

Incomplete contracts may be efficient contracts, even if the incompleteness is unintended. The costs of contractual completeness would often exceed the benefits, just as the costs of reducing crime or pollution or accidents to zero would exceed the benefits. Incomplete contracts will tend to be efficient when contracts are relatively complex, that is, when there are a large number of low-probability contingencies that could affect the value of contractual performance, and the efficient responses to those contingencies vary greatly and so cannot easily be specified in advance (Hadfield, 1994, p. 165, n.15). In these cases the transaction costs of negotiating, drafting, monitoring, and enforcing a complete contract are high.

More generally, in the language of institutional economics, a complete contract is only one form of 'governance mechanism' for guiding the behavior of contracting parties (Al-Najjar, 1995). Alternative governance mechanisms include the courts and extralegal enforcement, such as social sanctions and reputation. In this approach, incomplete contracts will tend to be efficient whenever governance mechanisms superior to a detailed contract exist, that is, whenever the opportunity costs of completeness are high. In fact, contrary to the usual economic approach, the actual historical development of contracts is probably best described as starting as incomplete as possible, then becoming more complete and formal as governance mechanisms other than the written contract proved to be inadequate.

The question of contract interpretation and implied terms is really a question of when the courts are a superior governance mechanism. Courts may be able through interpretation and implied terms to provide necessary flexibility - efficient adjustments to contingencies - that an incomplete contract otherwise lacks. Courts may also be superior to nonlegal institutions such as reputation because reputation effects may be weak due to such things as cognitive dissonance, optimism about the ability of a party with a poor reputation to change, the difficulty of knowing when a contracting partner has behaved badly, and the last period problem. In general, the role for courts in interpreting contracts and implying terms increases as contracts become more efficiently incomplete.

### **3. Incomplete Contracts and Contractual Intent**

Now suppose the contract is incomplete, as are most contracts that are the subject of litigation. What should a court do? The economists' (and courts') usual assumption is that courts should follow the intentions of the parties, but to admit incompleteness is to admit that the intention of the parties is uncertain, or at least disputed (some would say nonexistent). The next best solution is to adopt the term - or interpretive methodology - the parties would have chosen had they bargained over the matter, that is, presumed or hypothetical intent. But how is presumed intent determined?

There are two general possibilities on which economic analyses have focused (Hadfield, 1992, 1994, p. 161). First, courts might presume that complete contracting is both feasible and desirable. This presumption has both a positive and a negative component. On the positive side, the express terms of the contract are presumed to be the best approximations of the parties' intentions and deemed to create a complete contract. This strategy is usually referred to as textualism. On the negative side, if parties fail to write a complete contract, the incompleteness is presumed to be inefficient, whether unintended

or strategic, and the court's approach should be to deter this behavior and encourage complete contracting. This strategy is a variant of what has come to be known as penalty defaults (Ayres and Gertner, 1989), which is itself a variant of an old idea in the Austrian School of economics that individuals should bear the consequences of their actions so that they become more rational over time (for example, Wonnell, 1986, p. 520).

The second general approach involves a presumption that contractual incompleteness is unavoidable and/or desirable, due to limitations of money, time, comprehension and foresight (Hadfield, 1992, p. 259). The courts then fill in the gaps by presuming the parties intended to contract with reference to some standard external to the written contract. Courts might presume parties contracted with reference to their current (course of performance) or prior (course of dealing) conduct, or to the conduct and understandings of similarly situated parties (trade usage or custom or business mores). Strategies that focus on these presumptions, which are featured predominantly in the Uniform Commercial Code, are usually referred to as contextualist. Alternatively, courts might presume the parties contracted with the expectation that courts would fill in any gaps with a joint maximizing term that would have been written by rational parties under conditions of low transaction costs (Goetz and Scott, 1981). In practice, the joint maximization strategy will often dissolve into contextualism, as courts lack the data necessary to do pure joint maximization.

It is important to remember that all of these strategies involve presumptions. It is all too easy for courts or proponents of a particular strategy to criticize the alternatives as failing to hew closely enough to the parties' intentions, when in fact the parties' intentions in incomplete contracts are at least uncertain, and the question is which strategy is more likely to be successful at approximating these intentions. For example, suppose a buyer rejects goods delivered late after the market price drops below the contract price. A court might be called upon to decide whether to imply a good faith limitation on the buyer's ability to reject. A textualist might argue no on the ground that such an implication would be contrary to the parties' intentions as expressed in the time of delivery term. But the parties' intentions - whether actual or hypothetical - may well be that a good faith obligation should be implied rather than that the time of delivery term should be interpreted as absolute. A proposition that textualism, contextualism, penalty defaults, or joint maximization best represents the parties' intentions needs to be defended. Economic analysis can help to identify the conditions under which the various interpretive strategies are more likely to approximate the parties' intentions, and whether courts are better off pursuing a pure interpretive strategy or a mixed one.

#### **4. Default versus Mandatory Rules and Contractual Intent**

The recognition of incomplete contracting and the uncertainty of contractual intent renders problematic another distinction that has played an important role in economic discussions of contracts, namely default rules versus mandatory rules. The term 'default rule' refers to several different characteristics: (1) if the parties specify some contract term, the court will enforce that term; (2) if the parties fail to specify some contract term, the court will fill in the gap and supply one; and (3) if the parties fail to specify some contract term but do not want the court to fill in the gap, the court will honor that intent (that is, the gap-filling rule itself is a default). UCC § 2-305 on open price terms is a good example of a rule that satisfies all three characteristics. Default rules are usually contrasted with mandatory rules, which term can also refer to three characteristics. Mandatory rules can refer to situations in which the court knowingly: (1) imposes a term that contradicts a term the parties specified; (2) refuses to fill in a gap that the parties left when the parties wanted the court to fill the gap; and (3) fills in a gap that the parties did not want the court to fill in.

When economists refer to mandatory terms, they usually mean the first sense, that is the court rejecting a term the parties specified. An example would be a liquidated damage clause deemed to be a penalty, or a term deemed to be unconscionable. The usual critique of mandatory terms is that because they disregard the intentions of the parties, the parties who prefer these terms will be made worse off. For example, if a court imposes a stronger performance obligation on an obligor than the parties intended, then future obligors will extract a higher price, which is more than the obligee wanted to pay (else he would have paid for it originally) (for example, Easterbrook and Fischel, 1993, p. 431). This critique makes sense if contracts are assumed to be complete.

But once we allow for the possibility of efficiently incomplete contracts and unclear intent, it becomes much more difficult to distinguish mandatory rules from default rules. Take, for example, the implied duty of good faith, or the duty of loyalty in fiduciary contracts. Are these defaults or mandatory rules? That depends on how well one thinks the duty of good faith tracks contractual intent. If one believes that parties may write incomplete contracts for which they expect courts to fill in the gaps, the duty of good faith or the duty of loyalty might easily be viewed as a default. If the parties want a particular obligation that conflicts with what courts ordinarily view as good faith or loyalty, and they specify that obligation, courts will generally enforce it. This is the view espoused by Easterbrook and Fischel (1993). On the other hand, if one believes that courts use the duty of good faith or the duty of loyalty to fill in gaps that the parties did not want to be filled, or to reject obligations the parties thought they had fully specified, then the duty of good faith looks more like a mandatory term. UCC § 1-102(3) evidences this ambivalence about the good faith obligation.

The mirror image issue is presented by the doctrine of certainty, which says that courts may sometimes decline to fill gaps the parties have left in contracts. The doctrine could be viewed as a default if one is willing to presume that when the parties have left 'too many' gaps for the courts to fill, they do not have contractual intent, and if they do have such intent they will override the default by filling in the terms themselves. Alternatively, the doctrine could be viewed as a mandatory rule if one assumes that the courts use it to refuse to fill in gaps when the parties wanted them to.

The point is that the labels 'default' and 'mandatory' are conclusions that can mask the assumptions being made about contractual completeness and intent, and so do not by themselves resolve the questions of implied terms and interpretation.

### **5. Unintended or Strategic Incompleteness: Encouraging Better Contracting**

If the contracting parties wanted to write a complete contract but failed in some way, the failure can be viewed as analogous to an accident in tort law. The accident may occur because one or both parties failed to take cost-effective 'contract-based precautions' (Cohen, 1992, p. 949). Alternatively, one of the parties might make a contract incomplete to serve his strategic bargaining interests by withholding information. In either case, courts can use the doctrines of interpretation and implied terms to encourage the parties to 'facilitate improvements in contractual formulation' (Goetz and Scott, 1985, p. 264). One way to encourage better contracting is to encourage more complete contracts, that is, the greater use of express written terms. If a court is willing to 'insure' parties through flexible interpretations and implied terms it creates a classic moral hazard problem: the parties have less incentive to write good contracts themselves, for example contracts with more precise language. Doctrines such as the parol evidence rule encourage parties to write more complete contracts by giving more weight to the written document and limiting the extrinsic evidence courts can consider. Strict application of these doctrines may thereby increase the accuracy of contract enforcement (reduce contractual accidents) by reducing the interpretive risks of relying on extrinsic evidence (Eric Posner, 1998, p. 546).

As in tort law, the goal of encouraging better contracting makes economic sense if the precautions are cost-effective. That will be the case if one or both of the contracting parties face low *ex ante* transaction costs of drafting and monitoring express contract terms that *successfully* specify performance obligations in response to different regret contingencies, as well as if the expected losses from interpretive accidents are high (Eric Posner, 1998, pp. 543-547). Moreover, courts must be able to identify accurately situations in

which precautions are cost-effective. Usually, the best courts can do is to use proxies to make reasonable comparative judgments. In particular, in investigating precautions, courts can compare the capabilities of contracting parties and they can compare the contract in dispute to other litigated contracts (Eric Posner, 1998, pp. 553-561).

In comparing contracting parties, courts might conclude that one contracting party is the 'least cost avoider', or in this case the 'cheaper contract drafter', namely the party in a better position to clarify a term or to identify what should happen in the event of some contingency. This approach explains such interpretive rules such as *contra proferentum*, which encourage the party in the better position to draft a more complete contract to do so. Similarly, if one of the parties is a repeat contractor or is assisted by legal counsel and the other is not (as in many consumer contracts), imposing liability on the repeat and represented contractor in cases of contractual ambiguity or incompleteness will encourage that party to improve the terms of its contracts. In addition, if one of the parties has an informational advantage, imposing liability on that party could encourage similarly situated parties in the future to reveal the information. But there may not always be a 'cheaper contract drafter', or if there is, the necessary precautions might not be cost-effective. Such might be the case, for example, with a party who commits a 'scrivener's error' in a written contract, especially if the error is one that the other party could reasonably have noticed.

The alternative of comparing similar contracts rather than contracting parties can also yield some useful guidelines. For example, one piece of relevant evidence about *ex ante* transaction costs would be how common a particular term is in similar contracts. The more common a term, the more likely the costs of contracting over that term are low. Courts can then presume that most parties who wanted such a term would have contracted expressly for it and those who have not can be deemed negligent or strategic. Alternatively, one might argue that transaction costs are low for relatively 'simple' contracts or for 'crucial' terms. But even if courts are able through comparative analysis to identify simple contracts or common or crucial terms, there is a further difficulty: ease of contracting may not be a sufficient justification for imposing liability.

The reason is that encouraging better contracting does not necessarily mean encouraging greater contractual completeness; it may mean encouraging greater contractual incompleteness through reliance on implied terms. Under a majoritarian default approach to implied terms, courts would minimize transaction costs by choosing the mix of express and implied terms that most contracting parties would want. The majority of contracting parties might want courts to use implied terms, especially in well-developed markets, because they believe that will save on the costs of contracting, even if the transaction costs of contracting are relatively low. Alternatively, the majority of contracting parties might believe that relying solely on express terms - even those that

simply try to mimic implied terms - might be less reliable than relying on well-established implied terms either in conjunction with or instead of express terms; that is, they might fear court misinterpretation more than court misimplication. The only contracting parties who should be encouraged to contract more explicitly under this approach are those who have 'idiosyncratic' preferences. Thus, the fact that parties fail to contract expressly (or unambiguously) for a given term - even a common or crucial one - may simply be an expression of intent to be bound by the majoritarian understanding of that obligation.

An example of the majoritarian default approach is the rule that contracting parties 'in the trade' are bound by trade usages, even if they did not know about them. This rule encourages the parties in a trade to develop such usages (which are majoritarian understandings) and to familiarize themselves rapidly with these usages, hence reducing the need for heavily lawyered documents (Warren, 1981). Thus, implied terms serve as a public good, a standard set of contract terms that parties either accept or reject. The same majoritarian approach could also apply to the interpretation of express terms. The 'plain meaning rule' could be viewed as a way of encouraging contracting parties to learn the common (one might even say implied) meaning of words, thus reducing the need for and costs of elaborate definition and explanation.

Of course, the majoritarian approach to encouraging better contracting itself presents problems. For example, identifying the majoritarian default seems to call for an empirical inquiry, which courts are often ill-equipped to make, though to the extent that there is a recognized trade usage, or a course of dealing or course of performance, this problem is mitigated. Verkerke (1995) attempts to remedy this problem in the context of employment contracts by surveying employers about the discharge terms contained in their employment documents. He found that 52 percent of employers reported that their employment documents specified an 'at will' provision (the prevailing default), 15 percent reported that their documents contain a 'just cause' provision, and 33 percent reported that they do not have documents that address the issue explicitly (Verkerke, 1995, p. 867). He also found that larger firms and firms from more 'liberal' jurisdictions are more likely to contract explicitly for the at will rule. From these data, Verkerke concludes that the at will default is the majoritarian default. A more cautious conclusion would be that a broadly defined just cause provision is *not* a majoritarian default, but given the limitations many states have put on the at will doctrine and the possibility of unwritten (or written, but narrow) qualifications on the right to discharge, whether the majoritarian default is the strong form of the at will doctrine expressed in many employer documents or a more limited form is less clear.

An additional problem with the majoritarian default approach is the need to determine when the parties have contracted around the default. Goetz and Scott (1985) argue that it is often difficult for courts to tell whether parties are

using express terms to trump (opt out of) implied terms or merely to supplement them. That is, it may be difficult for courts to tell in a particular case whether the parties intended to incorporate implied terms by writing an incomplete contract, or whether they intended the express terms they used to create a complete contract; thus, the contractual 'accident' results from the parties' unintended failure to resolve the tension between the express terms and implied terms. The more courts favor and encourage implied terms and common usages, the more costly it becomes for the parties who want to contract out of those terms to do so. As discussed above, ostensible default rules begin to look more like mandatory rules. The courts' choice of interpretive strategy, therefore, may affect not only the parties' incentives to contract more expressly, but also their ability to contract around the implied default rule.

Goetz and Scott argue that the more likely it is that contracting parties will be unhappy with the court's implied terms and interpretations - the more heterogeneous contracting parties are likely to be - the more inefficient an expansive approach to implied terms and interpretation will be. In contrast, where contracting parties are more likely to engage in homogeneous and repetitive transactions - that is, where the transactional variance is low - the more likely a contextual approach will be efficient because it will foster the development of more standardized terms by trade groups, lawyers, and the parties themselves. One could also justify the contextual approach in such cases on the ground that in 'conventional' contracts, court error is likely to be low (Eric Posner, 1998, pp. 553, 556). Implementing this notion is often more difficult than stating it, however.

For example, Goetz and Scott suggest that in well-developed markets courts should generally allow context evidence to supplement express terms, but should generally not allow context evidence to override the plain meaning of express terms (Goetz and Scott, 1985, pp. 313-315). Eric Posner has recently criticized this argument on the ground that there is no theoretical justification for having a flexible approach with respect to incompleteness (implied terms) but a strict approach with respect to ambiguity (interpretation of express terms) (Eric Posner, 1998, pp. 559-560). On the one hand, it should not matter whether the parties use, for example, a best efforts clause or leave one out and let the court imply it; if the courts consider extrinsic evidence in one case, they should do so in the other. On the other hand, the 'plain meaning' of a best efforts clause requires a kind of context evidence, namely the general understanding of the clause. Thus, there may be no inconsistency in having a flexible approach to incompleteness and a plain meaning approach to ambiguity: both favor allowing a certain type of contextual evidence, namely general contextual evidence. The problem arises when the contextual evidence being considered is not general but specific to the contracting parties, such as course of dealing, course of performance, or prior negotiations. Here a flexible

approach to incompleteness would allow the specific context evidence to trump the general, but the plain meaning rule would have the general context evidence trumping the specific. At this level of generality, Posner's argument seems correct. Although one could imagine cases in which a court might want to use a flexible approach to incompleteness and a strict approach to ambiguity, it is difficult to make any general statements about such cases; in fact, one could just as easily imagine cases in which a strict approach to implied terms and a flexible approach to ambiguity would be appropriate. Goetz and Scott's argument about the plain meaning rule perhaps should be read as limited to express terms that are commonly understood as general trumping terms that override implied terms, such as merger clauses, disclaimers, or clauses granting one party broad discretion. If the parties go to the trouble of using such a general trumping term, then arguably that should be a sufficient signal of their idiosyncrasy. But even this interpretation is unsatisfactory because, as with the at will term discussed above, it may not be clear whether the parties simply intended to use the trumping clause to reject an overly broad implied term or whether they also meant it to convey the full measure of the parties' obligations to the exclusion of all extrinsic evidence.

The discussion in this section so far has assumed that *ex ante* transaction costs are low. The higher the *ex ante* transaction costs of drafting and monitoring become, the less likely it will be efficient for a court to adopt restrictive rules of interpretation and implied terms that encourage parties to contract more explicitly, because it will not be cost-effective for the parties to do so. Reliance on the types of contextual evidence discussed above now becomes relatively more cost-effective as the accuracy of the written contract declines. If courts take too restrictive a view of interpretation and implied terms, the development of cost-saving interpretive devices might be discouraged in favor of more complete, but costlier, writings (Burton, 1980, p. 373). Alternatively, too few contracts might be formed *ex ante*, as the promisor's costs rise to cover an anticipated remedy that the promisee does not value at this cost. And too much performance might occur *ex post*, as the promisor performs even when the cost of doing so exceeds the value of performance (Easterbrook and Fischel, 1993, p. 445).

Once again, stating the general principle may be easier than applying it. Classic examples of high-transaction costs contracts are principal-agent contracts usually referred to as 'fiduciary'. These contracts typically involve complex tasks for which the principal cannot easily measure the agent's effort or outcome, thus making express contracting difficult (Cooter and Freedman, 1991a, p. 1051; Easterbrook and Fischel, 1993, p. 426). Other examples include contracts between unsophisticated parties or long-term contracts. Even in high-transaction cost contracts, however, a more restrictive approach to interpretation and implied terms might be appropriate if the contracting parties'

preferences with respect to certain obligations are likely to be idiosyncratic, or equivalently if the relevant context evidence is less reliable (Eric Posner, 1998, pp. 557-558). By the same token, the same concerns raised by high-transaction cost contracts might exist even in ordinary sales contracts. For example, if a contract allows for a 10 percent variation in the quantity for the (unstated) purpose of avoiding liability over loss during transportation, a question might arise whether the seller could take advantage of this provision to deliberately increase or decrease the quantity as the market price drops or rises. Although one could say that the buyer could contract to prevent such behavior by, say, limiting the application of the quantity variation provision to losses suffered in transit (Gillette, 1981, p. 655), it may be quite difficult to draft such a clause. What should happen, for example, if both a market price change and damage to the goods occur? What about damage to the goods before and after transit? Is it always desirable to have the parties provide explicitly for all these contingencies? The point is that a given contract may be viewed as low-transaction cost for some purposes and high-transaction cost for others.

## 6. Deterring Opportunistic Behavior

Getting the mix of express and implied contracting terms right - that is, encouraging the optimally complete written contract - is only one consideration (and perhaps not the most important) that courts do or should face when deciding questions of interpretation or implied terms. A second approach to the question of how courts should interpret contracts and when they should imply terms focuses not on encouraging efficient *contracting*, but on deterring opportunistic contractual *behavior* (though obviously the two overlap). Opportunism can be broadly defined as deliberate contractual conduct by one party contrary to the other party's reasonable expectations based on the parties' agreement, contractual norms, or conventional morality (Cohen, 1992, p. 957). Alternatively, opportunism is an attempted redistribution of an already allocated contractual pie, that is a mere wealth transfer (Muris, 1981; compare Burton, 1980, p. 378). For example, a contract may require B to paint A's portrait 'to A's satisfaction' (Richard Posner, 1998, pp. 103-104). This provision allows A to reject the portrait even if others like it if it does not suit A's taste. But if A rejects the portrait for reasons other than unhappiness with the painting's quality - say because A remarries a spouse who does not want A's portrait in the house - A acts opportunistically.

The problem of opportunistic behavior is perhaps the key justification for court intervention in contracts. In general, 'the threat of opportunism increases transaction costs because potential opportunists and victims expend resources perpetrating and protecting against opportunism', which 'do not help produce

a commodity or service that the contracting parties mutually value' (Muris, 1981, p. 524). More specifically, opportunistic behavior makes complete contracting extremely difficult. Even if contracting parties could anticipate all of the possible changes in economic variables, they would have a much harder time anticipating and protecting against opportunistic behavior by the other party. At the extreme, the more one contracting party is willing to contemplate the possible opportunistic behavior of his contracting partner, the less likely he will be to want to contract with that partner at all. Some degree of trust is necessary for contracting to occur. More important, many seemingly airtight contract terms can seem awfully leaky once a clever lawyer and a highly motivated client get through analyzing them. Just as cartel members can often find ways to cheat on cartels involving the most standardized products, so disappointed contractors can often find a way to act opportunistically in the most standardized contracts. Because contracting parties cannot solve all problems of opportunism on their own, courts can reduce transaction costs by imposing liability on the 'most likely opportunist'.

But there are difficulties with using courts to deter opportunism. In particular, opportunism is often 'subtle', that is, difficult to detect or easily masked as legitimate conduct (Muris, 1981, p. 525). Contract performance disputes arise when one party becomes unhappy with the contract. This unhappiness may stem from the occurrence of a risk that party had contractually agreed to bear. However, the disappointed party might be able to exploit some contract term to claim that the other party had breached or to allow the contested behavior, even though the term was intended to handle another situation. Alternatively, the disappointed party might be able to exaggerate or misrepresent the extent of a contingency that might excuse his performance, and so escape his contractual obligations.

The problem that subtle opportunism poses for courts is often surmountable. In the fiduciary context, courts adopt, via the duty of loyalty, a strong presumption of wrongful misappropriation by an agent when that agent has a conflict of interest, engages in self-dealing, or withholds information from the principal (Cooter and Freedman, 1991a, p. 1054). More broadly, opportunism may be more possible whenever one party has a significant information advantage over the other. In other contexts, courts can find 'objectively verifiable circumstances that act as surrogates for the existence of opportunism' (Muris, 1981, p. 530). On the one hand, when the contract assigns a particular risk to one of the parties, and that risk materializes, the court should be skeptical of attempts by that party to escape his obligations via a different contract term. The classic example is a change in market price. If a buyer in a requirements contract suddenly experiences a large drop in 'requirements' after the market price has fallen below the contract price, or a large increase in requirements after the market price has risen above the contract price, the court

should suspect opportunism or, in legal terms, a violation of the implied obligation of good faith. On the other hand, whereas a change in market price suggests opportunism, a change in economic circumstances either not contemplated by the contract or whose risk the contract places on the party seeking strict enforcement, suggests a lack of opportunism. To return to the requirements contract example, if the buyer's requirements decrease or increase because of a change in costs or technology subsequent to the contract, the buyer's behavior is likely not opportunistic (is in good faith) because the very purpose of the requirements contract is to assign some risk of variation in the buyer's needs to the seller.

Another example of objectively verifiable circumstances on which courts can focus is *ex post* transaction costs. If the market for substitute performance is thick, opportunism is less likely (Goetz and Scott, 1983). Opportunism can occur only when it is costly to switch to a new contracting partner, that is, when at least one party has made sunk, specific investments. Although this test may be useful in establishing general presumptions, it is of limited help in deciding specific cases. Litigated cases tend to be precisely those in which *ex post* transaction costs are likely to be high; otherwise, the cases would be settled.

Although opportunism is often discussed as an *ex post* problem, opportunism can occur *ex ante* as well. For example, under a strict parol evidence rule, a party might intentionally make oral statements that the other party understands and relies on as part of the contract, then leave the provision out of (or put a contradictory provision in) the writing. One common situation is where a party tells the other to ignore the terms on the back of the first party's forms, then later tries to enforce those terms. On the other hand, under a more flexible parol evidence rule, a party might intentionally 'pad' the negotiation record with statements that party knows will be rejected by the other party both orally and in writing, in the hopes that the first party can later convince the court that these statements were in fact part of the contract (a common practice in legislative history) (Eric Posner, 1998, pp. 564-565). This latter form of opportunism helps explain why courts tend to be much more skeptical of evidence that the parties can easily manipulate - especially prior negotiations - than evidence over which the parties have less control - especially common usages. It may also explain the motivation behind the use of merger clauses as well as one reason why they should not be interpreted too broadly. It is difficult for a party to predict in advance which negotiation tidbit the other side might seize on later (Eric Posner, 1998, p. 572), so it is necessary to write a broad clause that excludes them all. The same is not true for less manipulable evidence, but it might be difficult to specify all such evidence in writing in advance, especially in a single 'anti-merger' clause.

It is important to recognize once again that the opportunism approach is dependent on determining contractual intent, which is often uncertain. Stating that courts do and should deter opportunism does not by itself explain how

courts do and should resolve the question of how to determine contractual intent; it simply opens the question up. Professor Muris, who first articulated the opportunism approach to good faith, recognized that to apply the approach courts need to consider 'risk allocation', which is a question of 'interpretation' that is 'analytically prior to [the question] of opportunism' (Muris, 1981, pp. 561-562, n.110). Nevertheless the opportunism approach may have something to say about how courts should go about determining intent. First, courts should hesitate to interpret a contract in such a way as to permit conduct that would ordinarily be understood as opportunistic. Second, courts should hesitate to attribute to contracting parties an intention not to have courts police against opportunistic behavior (compare Muris, 1981, p. 573, n.138). Because contextualism and textualism are both useful for deterring different types of opportunism, we should therefore expect - and we find - that courts are never completely committed to one or the other.

### **7. The Problem of Joint Fault or Multiple Contingencies**

In many contractual disputes, there are often precautionary steps that both parties could have taken to have avoided or mitigated the contractual loss. We have already considered one such precaution - drafting a better contract. Quite separate from the costs of drafting better terms are the costs of reducing the likelihood of, or harm from, some risk *ex ante*, and of mitigating losses *ex post*. Parties seeking to have the court imply or interpret a term in their favor may be attempting to avoid a risk that the contract assigned to them or to extricate themselves from a vulnerable position of their own making, which they could have avoided at low cost.

In these cases, courts may have to make judgments about the relative fault of both parties to decide whose behavior it is more important to deter in a particular case. In particular, if one party is the least cost avoider of some contingency while the other party regrets the contract for other reasons and is opportunistically seeking to avoid its obligations, courts face a 'negligence-opportunism tradeoff' (Cohen, 1992, pp. 983-990). To take a classic example, suppose a builder promises to use a particular brand of pipe in building a house but inadvertently substitutes a different, but functionally equivalent brand, a fact not discovered by the owner until the house is nearly completed. The owner refuses to make the final payment on the house. The court must choose between placing liability on the negligent builder or the potentially opportunistic owner. There is an economic case to be made that opportunism - if sufficiently proved - is more costly behavior and deterrence of that behavior should take priority (Cohen, 1992). On the other hand, the more likely it is that the builder 'built first and asked questions later' (Goldberg,

1985, p. 71), the more willing courts should be to find for the owner by implying a condition.

To take another example of the negligence-opportunism tradeoff, suppose that a buyer rejects goods delivered late after a market price drop and the seller sues. There are two contingencies here: the price drop and the late delivery. The contract assigns the risk of the price drop to the buyer and the late delivery to the seller. Textualism will not resolve this dispute: either the price term or the time of delivery term cannot be read absolutely. It is not sufficient to say that only the seller has breached, because what constitutes a breach and the consequences of that breach are precisely what is at issue. Nor can it be said that only the seller could take precautions here because neither party could do anything about the price drop and the buyer did not cause the delay in delivery. If the buyer's rejection is viewed as opportunistic behavior, then refraining from such behavior could be viewed as a 'precaution'. Depending on the circumstances, there is an economic argument to be made for implying a good faith 'limitation' on the buyer's ability to escape its obligations.

## **8. Court Error**

One of the main criticisms of courts' taking too contextualist an approach to interpreting and implying contractual terms is the problem of court error and incompetence. At one extreme, if courts make no errors in importing contextualist evidence, then such evidence should always be allowed, at least if the cost of producing such evidence is not too high. At the other extreme, if courts make too many mistakes in interpreting or implying terms, then textualism becomes superior if the transaction costs of contracting are lower than the expected savings resulting from fewer court errors (Eric Posner, 1998, pp. 542-544). If courts make the methodological error of choosing contextualism in situations of high court error, then the parties will respond by attempting to contract around the court's rules through detailed language or broad merger clauses, by avoiding courts (for example, arbitration) or contracts (for example, vertical integration), or by engaging in inefficient contractual behavior to adjust to the court's erroneous legal standard.

But the problem of court error does not necessarily favor textualism. In the first place, as Hadfield (1994) has argued, the feared inefficient responses to court error may not occur. Developing a formal model of good faith clauses in intentionally incomplete contracts in the presence of probabilistic court error, Hadfield concludes that the possibility of court error does not always caution against court intervention. If courts are of such low competence that the parties cannot reduce their marginal liability by improving their contractual efforts in a cost-justified way (that is, liability is essentially strict), then the parties will not change their behavior under the contract and will adjust to the anticipated

court error by adjusting the price of the contract rather than by declining to contract. On the other hand, if courts are of higher, but still limited, competence, then enforcement of good faith clauses may lead to greater joint profits for the parties than nonenforcement. This will occur if the court error does not have too severe an adverse effect on the parties' incentives, and if the private mechanisms for inducing optimal effort without court enforcement are relatively weak.

In addition, Hadfield argues that courts of low competence should not follow bright line rules or precedent, but instead should use standards. By bright line rules she means rules requiring a certain level of conduct that is independent of changing economic conditions; for example, a bright line rule might say to a supplier in an output contract that to act in good faith it cannot reduce its output to zero unless continued production puts the firm on the verge of bankruptcy. By standards she means required actions that vary depending on the economic circumstances, such as a rule that says an agent subject to a best efforts clause must adopt reasonable sales methods. Bright line rules thus correspond to textualism, whereas standards correspond to contextualism. Bright line rules may compound rather than ameliorate court error by a court of limited competence, because a bright line rule setting forth a required action will so often be 'wrong'. Thus, parties will respond to a bright line rule either by ignoring it or by conforming their behavior to the inefficient safe harbor established by the rule. Standards, by contrast, are more likely to encompass the 'efficient' response because courts using standards will set the minimum required action low and set the safe harbor high. Thus, contracting parties are likely to realize that their marginal liability can be reduced through increases in cooperative effort (because courts are likely to notice and take those efforts into account), and so the parties will be encouraged to take steps in the direction of optimal behavior. The point is that the presence of court error does not preclude the desirability of court flexibility.

A similar argument might apply even outside the relational contract context. The argument for textualism here is that if transaction costs are low, court error will be minimized because the parties will be encouraged to put more terms in the writing. Textualist courts will interpret this writing more accurately than contextualist courts, which will sometimes erroneously rely on contextual evidence in addition to the writing (Eric Posner, 1998, pp. 545-546). The argument assumes that transaction costs include, as has been suggested above, not merely the cost of drafting, but the cost of drafting in such a way that courts make fewer interpretive mistakes. But low drafting costs may not be sufficient to ensure that court error is reduced under textualism. If, for example, drafting costs decrease (as they probably have due to technological progress) so that it is relatively easy for parties to add more terms to their writings, court error could in fact increase if more detailed contracts are more likely to have conflicting terms or courts are more likely to misinterpret a term to cover a

particular contingency the parties did not intend to cover.

Another aspect of court error that some argue supports textualism is error in interpretive methodology, namely the choice between textualism and contextualism itself. The contracting parties may prefer textualism and express that preference through, for example, merger clauses. But if courts make errors in determining the parties' intentions generally, they will also err in determining the parties' methodological preference. Courts may therefore choose contextualism too often (Eric Posner, 1998, pp. 547-548, 570-571). But once again, this conclusion depends on the assumption that if courts use textualism (this time to decide the parties' methodological preference) they will err less often because the costs to the parties of accurately expressing their methodological intentions are low. One would think, however, that the costs to the parties of drafting a particularized methodological term are quite high. Methodological preference is only a second-order concern for the parties. It is difficult for the parties to predict how court error will likely impact the wide variety of possible disputes they might have, and methodological preference terms have no contractual use to the parties outside of litigation. As a result, it is not obvious *a priori* that choosing a textualist approach minimizes court error.

Suppose, for example, that the parties generally prefer a textualist approach and expect interpretation *x* of some term. There are actually three ways the court could err. The court could take a contextual approach but reach interpretation *x*. Or the court could take a textual approach and reach interpretation *y*. Or the court could take a contextual approach and reach interpretation *y*. Although the parties prefer the textualist approach, it might be more important to them that the court gets the term right, however the court does it. If courts are more likely to choose the desired interpretation *x* using a contextual approach and interpretation *y* using a textual approach - either because the parties underestimate the courts' competence with respect to that term or because their expressed preference for textualism inaccurately conveys the parties' correct estimate of the courts' competence in this instance - then error costs could be reduced if the court 'mistakenly' used a contextual approach.

To give a simple numerical example, suppose the court can choose either a textualist or contextualist methodology. If it chooses textualism, the likelihood of interpreting the term the way the parties want is 0.4; if it chooses contextualism, the likelihood of interpreting the term the way the parties want is 0.6. Suppose further that *ex ante* the parties would value the court's using textualism and choosing *x* at 100; would value the court's using contextualism and choosing *x* at 80; would value the court's using textualism and choosing *y* at 50; and would value the court's using contextualism and choosing *y* at 10. Thus, the parties prefer textualism to contextualism, but prefer the right outcome more. The expected value if the court uses a textualist approach is  $(0.4 @ 100) + (0.6 @ 50) = 40 + 30 = 70$ . The expected value if the court uses a

contextualist approach is  $(0.6 @ 80) + (0.4 @ 10) = 48 + 40 = 88 > 70$ .

The point is that the possibility of court error does not always argue in favor of textualism. Both textualist and contextualist methodologies lead to court error. The real question is which methodology has the lowest error rate and at what cost. It is hard to answer this question in the abstract. This may help to explain why courts do not - and never will - use pure interpretive methodologies, but tend to switch back and forth depending on the circumstances.

## 9. Summary and Future Research

To a large degree, the economic approach to interpretation and applied terms parallels the approach in other areas of contract law. Court intervention is most justifiable when transaction costs are high and the likelihood of court error is low. Transaction costs include not only the *ex ante* costs of drafting in such a way as to reduce court error, but the *ex post* costs associated with sunk specific investments that make possible opportunistic behavior, as well as the costs of alternative governance institutions such as extralegal sanctions. Most of the economic arguments that suggest a restrictive court approach to interpretation and implied terms have counterarguments. Therefore the institutional and contractual context matters greatly in deciding what approach efficiency-minded courts should take. The literature to date has mapped out the broad contours. Future work will have to do the hard digging. That means paying more attention to why people write the contracts they do and the circumstances that motivate nonperformance.

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