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Abstract: For the past 100 years or so the historical trend in the law of contracts has been to water down formal interpretive doctrines in favor of a more all-things-considered analysis of what the parties may have meant or what justice might require in the individual case. This trend away from formal and toward substantive interpretation of contracts has been alternately celebrated and criticized for over a century; and in recent years, a number of economically influenced scholars, in translating some of the classic arguments into economic language, have helped to clarify some of the traditional commentators' concerns. While this new economic analysis of formalism has been relatively successful in relating the traditional debates over formalism to specific transactional and institutional problems such as imperfect information and rent-seeking, however, it has fallen short along the dimension of advancing toward practical legal or policy recommendations. This essay, accordingly, proposes a different approach: one that focuses on private rather than public legal decisionmakers as a primary audience. In general, private lawmakers are likelier to be in a better position to make practical use of the economic analysis of contracts, in part because the detailed information that is necessary to implement such analysis intelligently is much likelier to be available at the individual level. Furthermore, there are many opportunities for contracting parties to choose between relatively formal and relatively substantive interpretive regimes. What is needed is a basic taxonomy of economic considerations that can serve as an organizing framework for parties choosing between form and substance when designing contracts; and the later part of the essay attempts to establish such a taxonomy.

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The Economics of Form and Substance in Contract Interpretation

Avery Wiener Katz
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I. Introduction: reframing the problem of form versus substance

Under the modern American law of contracts, almost all applications of legal doctrine come down to questions of interpretation; and almost all questions of interpretation implicate the tension between form and substance. In one sense, of course, this claim is neither remarkable nor distinctive. In order for any legal rule or standard to have an effect on human behavior, it must be applied to particular cases; an agent seeking to enforce or comply with a given regulation must determine its content and then compare it to a specific factual context.¹ Accordingly, the materials admissible at the interpretive stage, the manner in which interpretation is carried out, and the parties' expectations regarding the interpretive process, will all significantly shape the contract's incentive and insurance properties.

In another sense, however — one familiar to specialists and scholars in the field — interpretation looms especially large in 21st-century U.S. contract law, because under the doctrinal provisions and practices as they have historically developed, the prescribed interpretive process is a relatively elaborate and intensive one. The set of materials considered relevant to interpretive inquiries is broad; and reasonably thorough attention to such materials is expected from those applying either the law or the language of individual agreements. As a result, the definitive resolution of interpretive questions requires a relatively larger degree of time and effort than would be the case if we had a system that put stricter limits on the

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1. For instance, a contract that provides that the seller must deliver six boxes of widgets by mid-July or face liability for the buyer's lost profits requires an performing or enforcing agent to determine, inter alia, what objects count as widgets and boxes, what acts count as delivery, which dates in July count as mid-July, what flows of costs and benefits count as profits, and, as a prerequisite to all of these, whether the contract ever attained the status of a legal obligation. Each of these determinations requires the agent to gather and consider evidence, and then to engage in an act of interpretation based on that evidence.

materials to be considered or on the resources to be devoted to their consideration. Conventional scholarly wisdom, indeed, holds that contractual disputes are more difficult and expensive to resolve in the United States today than in other common-law countries such as England or Canada, or than in earlier historical periods such as the early to mid-20th century, in part because of the greater resources demanded at the interpretive stage.²

This question — how broad and thorough should the interpretive process be? — is commonly articulated in terms of the dichotomy of form and substance. As such, it has long been a matter of professional and academic debate, and has been widely discussed in both case law and commentary. Viewed from a pedagogical perspective, it surely presents one of the central conceptual themes of the first-year contracts class. (Not to mention that it also underlies longstanding controversies in public law subjects such as administrative and constitutional law, as well as in the field of theoretical jurisprudence.³)

More specifically, many rules⁴ of contract law have the effect of privileging or emphasizing certain types of potentially relevant interpretive materials, and discounting or excluding others. Such rules are often termed "formal" or "formalistic" because they confine the interpreter's attention to a subset of materials that may or may not accurately reflect or give rise to the same inferences as would the universe of materials as a whole. A more "substantive" approach to contract interpretation, in contrast, would attempt to come to a more all-things-considered understanding, based on all the materials reasonably available.

For example, the Statute of Frauds requires that certain agreements be expressed in writing before they can be enforced. The Statute is subject to many well-known exceptions, but its general effect is to confer special status on the written document as a determinant of contractual liability. The parol evidence rule, which provides that a written document that

2. See, e.g., P.S. Atiyah & Robert S. Summers, *Form and Substance in Anglo-American Law: A Comparative Study of Legal Reasoning, Legal Theory, and Legal Institutions* (1987); Robert S. Summers, *Instrumentalism and American Legal Theory* 136-59 (1982); additional citations to be provided. In general, in this preliminary draft, I have not attempted to provide complete citations for propositions that would be reasonably familiar to (or at least conventionally accepted by) specialists in the field.

3. Cites. This could be a multi-page footnote, but I promise I'm not going to let it come to that.

4. For the sake of convenience and brevity, unless the context otherwise requires, in this essay I will use the term "rules" to denote any doctrine or principle that has recognized legal status. Rules used in this way thus includes principles, standards, etc.

integrates the parties' agreement may not be contradicted or varied by evidence of prior or contemporaneous oral understandings, has a parallel effect. Similarly, the law confers special significance on certain stereotypical symbols or gestures such as the seal (before it was abolished in most jurisdictions⁵), or to the use of commercial terms of art such as "f.o.b."⁶ Even the classical doctrine of consideration has been famously explained and justified in such terms.⁷

As is well known to both students and scholars of contract law, however, for the past 100 years or so the historical trend across the board has been to water down such formal doctrines in favor of a more all-things-considered analysis of what the parties may have meant (or what justice might require) in the individual case.⁸ The relative balance of formal and substantive approaches to interpretation varies among jurisdictions and among subfields of contract law, of course, and between statutory and common-law doctrines, with Article 2 of the Uniform Commercial Code perhaps representing the avatar of contemporary anti-formalism.⁹ But one sees this trend played out in all corners of the law of contracts: in the decline of the classical doctrine of consideration and the associated rise in influence of the doctrine of promissory estoppel¹⁰; in the movement from traditional notions of caveat emptor and the duty to read to the modern reasonableness-based approach to adhesion contracts¹¹; in the Second Restatement's de-emphasis of the distinction between unilateral and bilateral contracts¹²; in

5. Citations.

6. See UCC 2-319.

7. Fuller, Consideration and Form; Holmes' famous aphorism in *The Common Law* that "consideration is a form as much as a seal".

8. See generally Eric Posner, The Decline of Formality in Contract Law, in *The Fall and Rise of Freedom of Contract* 61 (F. H. Buckley ed. 1999) [hereinafter E. Posner, *The Decline of Formality*].

9. Danzig, *The Jurisprudence of the Uniform Commercial Code*; Robert E. Scott, *The Uniformity Norm in Commercial Law: A Comparative Analysis of Common Law and Code Methodologies*, in *The Jurisprudential Foundations of Corporate and Commercial Law*, ed. Kraus & Walt [hereinafter Scott, *The Uniformity Norm*].

10. See, e.g., Gilmore, *Death of Contract*.

11. See sources cited in my Rand article.

12. See, e.g., Restatement (Second) §§32,62.

the development of doctrinal categories such as requirement and options contracts that render enforceable arrangements that half a century ago would have fallen afoul of traditional doctrines of mutuality and indefiniteness¹³; in the decline of the perfect tender rule in sales law and the associated expansion in the doctrine of substantial performance¹⁴; in the decline of the mirror image rule as a device for resolving the battle of the forms in favor of UCC §2-207's test of material difference¹⁵; and in the growth of the importance of the duty of good faith.

This trend away from formal and toward substantive application of contract law has been alternately celebrated and criticized. Its defenders (e.g., Corbin, Llewellyn, Traynor, Gilmore, Macneil) have emphasized the mismatch between traditional formal categories and the complexity of commercial reality, and have argued that a more substantive approach is required to do justice to actual bargains and to protect commercial expectations. Its critics (e.g., Williston, Hand, Epstein) have countered that contracting parties can adapt quite well to formal categories so long as the application of such categories remains clear and stable, and that substantive approaches, especially when applied by non-specialist judges operating at a distance from the commercial setting and susceptible to influence by a host of popular and ideological considerations, tend to undermine the certainty of exchange and to defeat the parties' intentions.

A. The economic commentators' views on the form/substance questions

The arguments of these two camps have framed both professional and academic discussion of contract law for over a century. Until recently, however, contracts scholars influenced by the economic approach to law have had relatively little to add to the form/substance debate. Instead, they have focused their attention on direct incentives for primary behavior such as performance, breach, and reliance investment, and on doctrines and devices governing the allocation of risk, and have generally scanted interpretative problems.

The main exception to this last generalization is the flourishing literature on default rules, which discusses what courts should do when a contract is incomplete, silent or ambiguous

13. See UCC 2-306, etc.

14. Compare *Jacob & Youngs v. Kent* with *Kreyer v. Driscoll*.

15. Compare *Poel* with *Roto-Lith* with *Dorton & Collins v. Aikman*.

with regard to a particular term.¹⁶ Contributors to this literature have argued that default rules should be designed to minimize the direct costs of writing contracts by choosing terms that most parties would want, to encourage the private development of contractual terms of art, to discourage opportunism and rent-seeking in drafting and performance, to encourage relatively informed parties to disclose their private information up front, and to minimize the costs of ex post bargaining a la Coase.¹⁷ The creation of a default rule, however, still leaves parties and their agents with the problems of determining when it comes into play, how to tell whether the obligations prescribed by the rule have been satisfied, what the parties must do to overcome the presumption that the rule applies, and how to interpret their efforts when they try.¹⁸ All of these determinations require interpretations; and such interpretation could in principle be either formal or substantive¹⁹. On this last question, the default rule literature has had little to say.²⁰

In the last several years, however, a number of economically influenced scholars have turned their attention to the general issue of form versus substance, and in translating some

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16. For instance, if a contract for the sale of goods makes no mention of warranties, should the court interpret the contract as containing implied warranties of merchantability and fitness, or as providing for *caveat emptor*? Similarly, if a sales contract makes no mention of price, should a court fill the gap with a reasonable price measured at the time of delivery (the rule under U.C.C. §2-305), a reasonable price measured as of the time of the making of the contract (the rule under the UN Conference for the International Sale of Goods, Article 55), or decline to enforce the contract entirely?
 17. See, e.g., Goetz and Scott, Ayres and Gertner, Craswell, the USC Interdisciplinary L.J. symposium, and too many others to list.
 18. To illustrate, the implied warranty of merchantability provides a default rule regarding product quality in cases where the seller is a merchant; absent contrary agreement, the goods are supposed to be of a quality that would pass without objection in the trade, be fit for the ordinary purposes for which such goods are used, and the like. Under UCC §§2-314, however, the definition of merchantability turns on the nature of the goods the parties understand themselves to be exchanging; and under UCC 2-316, the merchantability warranty can be disclaimed by a conspicuous writing mentioning the word "merchantability," by the buyer's inspection of the goods, by course of dealing, course of performance, or usage of trade, or by an expression such as "as is" that "in common understanding calls the buyer's attention to the exclusion of warranties and makes plain that there is no implied warranty."
 19. The UCC, of course, makes plain that the inquiry is to be a substantive one. See various provisions and official comments, including 1-201(3) on the definition of "agreement."
 20. See Eric Posner's Penn piece on the parol evidence rule (critiquing the default-rule literature on this basis). But see Ayres and Gertner's discussion of tailored vs untailored default rules, to be discussed below.

of the traditional arguments over this issue into economic language, have helped to clarify some of the traditional commentators' concerns.²¹ In the field of contracts in particular, this has resulted in somewhat of a renaissance of formalist arguments — or what one commentator has called "anti-anti-formalism."²²

The most prominent of the new wave of contractual formalists is perhaps Lisa Bernstein, who, in a series of articles detailing the practices of contracting parties in a variety of specialized markets (including the diamond, grain, and cotton trades), has argued that buyers and sellers who deal regularly in a given market prefer to have their disputes governed by the private rules and procedures supplied by their individual trade organizations in large part because those rules and procedures are more formalistic, and thus provide more certainty and protection at lower cost, than those that would be applied by generalist courts applying the UCC.²³ But other stalwarts of the economic approach to contract law, including Robert Scott and Alan Schwartz, have also joined the formalist bandwagon (or perhaps have been driving it all along). Scott in particular has been arguing for some years when government lawmakers attempt to develop complex substantive regulations or default rules, or when they look deeply into context when engaging in interpretive inquiries, they discourage private actors from developing their own arrangements for dealing with the underlying transactional problem. Because state lawmakers can only operate at a general level, while private solutions to transactional problems are likely to be better tailored to the needs of individual contracting parties, Scott concludes that clear and simple interpretive rules are best, even if on their face they appear to direct less than efficient outcomes.²⁴ More recently, both Scott and Schwartz,

21. See, e.g., Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 *Duke L.J.* 557 (1992) [hereinafter Kaplow, *Rules Versus Standards*]; Louis Kaplow, *A Model of the Optimal Complexity of Legal Rules*, 11 *J. Law, Econ. & Org.* 150. (1995) [hereinafter Kaplow, *Optimal Complexity of Legal Rules*].

22. David Charny, *The New Formalism in Contract*, 66 *U. Chi. L. Rev.* 842 (1999)

23. Cite various of Bernstein's articles here, especially the one where she shows that private industry tribunals and arbitral panels, in contrast to government courts applying the UCC, typically make little use of information regarding trade usage and course of dealing, notwithstanding the fact that as trade specialists, their ability to gather and evaluate such information is likely to be substantially superior to that of generalist judges.

24. Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 *Cal. L. Rev.* 261 (1985); Robert E. Scott, *A Relational Theory of Secured Financing* 86 *Colum. L. Rev.* 901 (1986); Robert E. Scott, *A Relational Theory of*

drawing on work in the economic theory of incomplete contracts, have argued that many common contractual devices are designed as responses to the fact that generalist courts cannot effectively (that is, at reasonable cost and with reasonable accuracy) determine the facts necessary to enforce the parties' substantive bargain as they ideally would wish it to be enforced in a world of full and free information. For courts to ignore these limitations and to try to enforce contracts as if they operated in a full-information world, they argue, disservices the parties' bargain and reduces the expected value of their exchange.²⁵

The arguments of the new economic formalists have not gone unchallenged. With regard to lawmaking in general, Louis Kaplow has shown using a formal decision-theoretic model that the optimal choice between rules and standards, and the optimal level of complexity of legal rules, depends upon empirical considerations such as the relative cost of ex ante and ex post decisionmaking, the costs of information acquisition, and the probability that a dispute will arise.²⁶ While limits on judicial competence do provide a reason to follow simple rules, in general one cannot conclude that rules dominate standards or that simplicity dominates complexity for all or even most purposes. In the field of contracts in particular, Eric Posner has defended a more balanced view of formal and substantive approaches to interpretation, suggesting that under some circumstances — especially those in which the contracting parties are boundedly rational, endowed with asymmetric information, or following a suboptimal convention — courts can improve social welfare by pursuing a liberal interpretive approach.²⁷ Posner has also pointed out that even were we to make the extreme assumption that courts were completely unable to determine the contracting parties intentions or the underlying facts of a contractual dispute, it would still not necessarily follow that courts should take a passive

Default Rules for Commercial Contracts, 19 J. Legal Stud. 597 (1990)

25. Alan Schwartz, Relational Contracts and the Courts: An Analysis of Incomplete Contracts and Judicial Strategies, 21 J. Legal Stud. 271 (1992); Alan Schwartz, Incomplete Contracts, 2 New Palgrave Dictionary of Economics and Law 277 (1997); Robert E. Scott, The Case for Formalism in Relational Contract, 94 Nw. U.L. Rev. 847 (2000). See also work by Victor Goldberg, Gillian Hadfield, Benjamin Klein, and others.

26. See Kaplow, *supra* note __.

27. Eric A. Posner, The Parol Evidence Rule, the Plain Meaning Rule, and the Principles of Contractual Interpretation, 146 U. Pa. L. Rev. 533 (1998) [hereinafter E. Posner, The Parol Evidence Rule]; Karen Eggleston, Eric A. Posner, and Richard Zeckhauser, The Design and Interpretation of Contracts: Why Complexity Matters, 95 Nw. U. L. Rev. 91 (2000);

or literal approach to interpretation. Under some circumstances, he suggests, even incompetent courts could promote cooperation and deter opportunism by providing a means whereby an aggrieved party could credibly invoke a mutual penalty. Increasing the complexity of legal proceedings, on this view, serves to increase the size of this threat, even if it does little to improve the accuracy of the result in those cases that actually go to trial.²⁸

From the standpoint of the goal of clarification, the new economic analysis of formalism has been relatively successful in relating the traditional debates over formalism to specific transactional and institutional problems such as imperfect information, risk allocation, rent-seeking and bounded rationality. Where the recent commentary has fallen short, however, is along the dimension of advancing toward practical responses to the form/substance dilemma.

This is so for two reasons. First, because the difference between the formalist and anti-formalist positions is a matter of degree rather than kind, resolving their arguments comes down in practice to line-drawing. Even ardent neo-formalists like Bernstein or Scott agree that courts should depart from formalist methodology in certain circumstances — for instance, when there has been a credible allegation of fraud or error in transcription. (Just as courts following the relatively formalist First Restatement version of the parol evidence rule made exception for cases of fraud and mistake.) Conversely, even advocates of a more liberal interpretive approach acknowledge that their position demands that courts or other law-applying actors possess at least minimal interpretive competence. But the proper compromise between form and substance, if it is to be based on utilitarian considerations, depends on an empirical judgment, made over the universe of potential cases, of how the relevant informational and transactional factors balance out. The very limitations of rationality and information that lead neo-formalists to conclude that courts should not engage in substantive interpretation and that legislatures should not enact vague standards that require a substantive application also prevent us from drawing the proper limits between formal and substantive approaches with any confidence. To put it conversely, if state actors know enough to set the appropriate boundaries on formalism, they are already significantly along the way to being able to do away with formalism entirely. Absent such knowledge, the setting of boundaries — like the application of substantive interpretation in any given case — is a matter of guesswork.

28. Eric Posner, A Theory of Contract Law Under Conditions of Radical Judicial Error, 94 *Nw. U. L. Rev.* 749 (2000) [hereinafter E. Posner, Radical Judicial Error].

Second, as Schwartz and Scott have shown in their influential work on the political economy of the American Law Institute (and scholars in the field of positive political theory have shown generally), legislative bodies that are charged with the promulgation of generally applicable regulations and that are also institutionally responsible to a diverse set of interest groups will tend to favor standards over rules and vagueness over simplicity.²⁹ The positive imperatives of lawmaking thus lead naturally to interpretive conventions that disfavor formalist decisionmaking. This phenomenon may be somewhat less pronounced for common-law courts, perhaps due to the influence of interjurisdictional competition and litigant initiative, but even so the process of common-law development, with its continual generation of exceptions and counter-principles, can erode the clarity and simplicity of legal doctrine.³⁰ In a federalist legal system in which the choice between formal and substantive approaches can be made at a local level, furthermore, different jurisdictions may adopt different interpretive stances for reasons of their own.

B. An alternate perspective: private ordering over form and substance

Given that new economic analysis of formalism does not offer clear policy prescriptions for governmental reformers, or an operational program for implementing such prescriptions, what is the next move? In this essay, I propose a different approach: one that focuses on private legal decisionmakers as the primary audience, rather than public ones. Note in this regard that virtually all of the above-mentioned commentators direct the bulk of their advice to governmental or quasi-governmental officials, even — indeed, especially — neoformalists like Schwartz and Scott. The advice may be that state actors should keep their hands off private contractual arrangements and restrict themselves to the relatively mechanical task of applying formal rules, but it is advice to state actors nonetheless. There are some exceptions to this blanket statement: Bernstein, for instance, in her articles on private commercial law regimes, focuses in her explicit discussions on a largely positive analysis, and is content to

29. Alan Schwartz and Robert E. Scott, *The Political Economy of Private Legislatures*, 143 *U Pa L Rev* 595 (1995)

30. Cite one of the classic Legal Realist critiques of formalism in this regard, also perhaps the literature on the efficiency of the common law, also Jason Johnston, *Uncertainty, Chaos, and the Torts Process: An Economic Analysis of Legal Form*, 76 *Cornell L. Rev.* 341 (1991).

leave her normative critique of the UCC's interpretive approach as implicit.³¹ Posner also spends a significant amount of time in his articles discussing the likely responses of private actors to the various interpretive policies that courts and legislatures might adopt.³² But this discussion — which he calls a positive analysis rather than a normative one — operates in the overall context of his analysis merely as an instrument that he uses to develop guiding principles for government lawmakers.³³ He does not consider, except incidentally, the possibility that his analysis could be useful to private actors.³⁴

As I have argued elsewhere, the almost-exclusive focus in the mainstream law-and-economics literature on a hypothetical audience of public lawmakers constitutes a severe misallocation of intellectual resources.³⁵ Even if we thought the relevant officials were inclined to take our advice, and even if we thought they had sufficient ability and incentive to apply that advice fruitfully to actual policy and legal questions, we would still be ignoring the entire population of potential private lawmakers and neglecting the possibility that their efforts could also contribute to an increase in social welfare. Unless one thinks that private incentives for lawmaking are necessarily at odds with the public interest, or that private lawmakers' theoretical and practical knowledge already provides them with a fully adequate basis for enlightened lawmaking — or, more threateningly to our scholarly self-esteem, that private lawmakers would be even less inclined to pay attention to our writings than public ones — this failure to address their perspective does not make economic sense. It seems unlikely that the marginal contracts article addressed to courts or legislators, on top of all such articles that have been written and published over the past decades, would have higher value added than an article or two focused on basic principles of transactional efficiency, and

31. Or to reserve it for unpublished oral remarks that accompany the conference or workshop presentations of her papers, thus preventing subsequent scholars from making full use of this contextual background in their subsequent responses to her — a formalist approach in style as well as substance!

32. Cite to specific discussions in E. Posner, *supra* note x.

33. *Id.*

34. *Id.* at ___ (observing, as an aside, that heterogeneity among contracting parties implies that they should be permitted the freedom to choose *ex ante* between formal and substantive interpretive regimes of law.)

35. Avery Katz, *Taking Private Ordering Seriously*, 144 U. Pa. L. Rev. 1745 (1996).

directed toward a hypothetical audience of private contract lawyers.³⁶ Moreover, the detailed information that is necessary to implement these principles intelligently is much likelier to be available at the individual level than at the level of the system as a whole. Private lawmakers may thus be in a significantly better position to make practical use of the economic analysis of contracts than public ones.

The value of refocusing attention on planning problems faced by private lawmakers, I think, is even greater with regard to basic problems of interpretation of the sort studied in the first-year contracts class. Most of the scholarly literature in the area is court- and case-centered, and thus tends to emphasize the aspects of interpretation that are central to the subjective experience of courts when deciding disputes. But as we know, many more contracts are written than are litigated, and the majority of our students that practice contract or commercial law will practice on the transactional side. Few of them will be judges or legislators, most of them will never be in a position to persuade a judge or legislature to change the law, but all of them might benefit from a clearer understanding of the practical consequences of formal and substantive interpretive strategies.

Taking a transactional approach to the problem of form and substance also helps emphasize the fact that, for all the discretion that courts and other arbiters may have with regard to interpretive questions, there are things that contracting parties can do *ex ante* to increase the chances that interpreting actors will follow the contractors' wishes *ex post*. For instance, if the parties want to limit courts' investigations into the history of their negotiations, they can and often do put a merger clause into their written contract, stating that the writing expresses their entire agreement and that all prior understandings or agreements have been merged into it. Such a clause will not serve as an absolute guarantee that the agreement will be enforced as written, but it does make a difference. While courts still retain the power to ignore merger clauses if they conclude that circumstances warrant, the use of the clause still tends as a practical matter to discourage courts from engaging in more free-form styles of interpretation, which is why contracting parties continue to use them even in jurisdictions that take a liberal approach to the admission of parol evidence.³⁷

36. Cf. Ronald J. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 Yale L.J. 239–313 (1984)

37. Cites.

There are, in fact, many opportunities for contracting parties to choose between relatively formal and relatively substantive interpretive regimes, and to have their choices matter; the merger clause is just one prominent example. No-oral modification clauses provide another: parties to sales transactions can provide, pursuant to UCC §2-209, that any modifications to their contract must be in writing. While such clauses do not prevent courts from using the equitable doctrines of waiver or estoppel to find that the contract has been varied, they still reduce the likelihood of such a finding, and it is possible to add additional clauses to the original writing that discourage the assertion of such claims. (Similarly, while the common law of contracts does not recognize no-oral-modification clauses as an official formal device, the presence of such a clause certainly raises the bar for anyone who subsequently tries to claim that a contract has been so modified).³⁸

Another common way for the parties to choose among interpretive regimes is by choosing which jurisdiction's laws govern the contract, since jurisdictions can vary considerably in their level of formalism. Virginia and Texas, for instance, continue to follow a traditionally strict version of the parol evidence rule, while California and New Jersey are famous for taking more liberal approaches.³⁹ New York and Connecticut continue to take different positions with regard to the formal effectiveness of an accord and satisfaction, even though the question is ostensibly governed by a uniform statute.⁴⁰ In the area of international sales, the UCC, however anti-formalist it may seem when compared to the traditional common law, is in many ways less formal than the alternative regime provided by the UN Convention on the International Sale of Goods, which rejects both the Statute of Frauds and the parol evidence rule.⁴¹ Choice-of-law clauses are common in commercial contracts, and while policy considerations such as consumer protection place some limits on their enforcement, at least in the commercial setting they are usually implemented as written.⁴² While there are many reasons for the parties to choose to be governed by a given legal regime, procedural simplicity

38. Cites.

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41. On the other hand, the CISG's offer and acceptance rules are more formalistic than the UCC's. Compare §§2-204 and 2-206 to CISG Articles ____.

42.

and the ease of resolving disputes is a common motivation, and in that regard the level of formalism is an important factor.

Similarly, parties can often specify the forum in which contractual disputes will be heard, either by specifying a particular location where any litigation must be brought, or, as increasingly common, by providing *ex ante* for private arbitration. Even if the substantive law to be applied to the contract is ostensibly the same, tribunals in different locations may be more or less inclined to delve into contextual matters, due to differences in jurisprudential approach, local legal culture, procedural and evidentiary rules, case loads, or other resource constraints. Private arbitrators are subject to similar variations, and face further incentives to formalize their interpretive practices in order to lower the cost of their proceedings, guard against suspicions of partiality, limit their exposure to judicial supervision, and attract future business.⁴³

Like choice-of-law clauses, forum-selection and arbitration clauses are not always enforced strictly according to their terms, and may be disregarded by courts willing to look beyond the face of the clause for interpretive evidence, or to override the clause in favor of some countervailing policy or principle.⁴⁴ But such clauses do receive some weight in practice; many courts enforce them presumptively; and there are self-interested reasons for even anti-formalist courts to defer to them. Parties who favor a more formal interpretive approach, accordingly, have significant leeway to choose to have their disputes heard by tribunals who share their philosophy (as Bernstein's discussions of private trade tribunals suggest.)

Contracting parties also may opt into a formalist interpretive regime by using a stereotypical legal device such as a negotiable instrument or letter of credit. Such commercial specialties are governed by distinct bodies of law, descending in part from the law merchant, that reflect a more formalist jurisprudential philosophy than does the common law of contracts generally. A holder in due course of a negotiable instrument, for instance, is entitled to enforce the instrument against its maker or indorser even if, based on the specific transactional facts, the defendant would have a good defense to liability on the underlying

43. Cite Bernstein on arbitration, also Stephen Ware and Andrew Guzman on the difficulty that courts face in ensuring that arbitrators apply substantive legal rules in the same way that courts would.

44. Cite here cases that invalidate forum-selection and arbitration clauses on unconscionability or adhesion-contract grounds; also state statutes that limit the scope for forum selection (especially in response to the UCITA controversy?)

contractual obligation.⁴⁵ Similarly, the liability of the issuer of a letter of credit depends solely on whether the beneficiary presents documents that facially comply with the payment conditions provided in the letter. The issuer is not authorized to inquire into the truth of any representations contained in the presenting documents, and is entitled to demand strict compliance with all payment conditions, in marked contrast to the more liberal rule of substantial compliance that would be imposed under the ordinary law of contracts.⁴⁶ The parties to an exchange do not have to use one of these specialized devices, but they may choose to, and often that choice is exercised with the express goal of contracting into a more formalistic interpretive regime. A prominent illustration is provided by the rise in popularity of the standby letter of credit, which in economic terms is a close substitute for the common-law suretyship or guaranty, but which in legal terms is governed by a substantially more formalistic body of legal doctrine.⁴⁷

Finally, contracting parties can often implement a more formal interpretive regime with regard to particular aspects of their agreement through the use of specific stipulations. The most familiar case of such a stipulation is the standard liquidated damage clause. By liquidating damages in their initial agreement, parties reduce the likelihood that a court will engage in an substantive inquiry into the actual state of damages *ex post*. A reduced likelihood is not a guarantee, of course, since courts will still supervise a liquidated damages clause to ensure that it does not work a penalty, and some courts remain resistant to the use of liquidated damages in cases where damages are amenable to *ex post* calculation. But by adopting such a clause, the parties do buy themselves somewhat greater formality, and in practice perhaps a presumption of enforceability. Similar stipulations regarding other terms of the agreement have an analogous effect.⁴⁸

45. UCC 3-305(b). The HDC's rights are subject to the so-called "real" defenses, which include infancy, duress, illegality, lack of capacity, discharge in bankruptcy, or essential fraud, but not subject to ordinary defenses such as mistake, misrepresentation, or failure of condition.

46. Compare UCC 5-108 with Restatement (Second) of Contracts §357; see also UCC 5-108, comment 1.

47. See sources cited in part V of my Chicago guaranty article.

48. See, e.g., UCC 1-102(3), which provides that although duties of good faith, reasonableness, diligence and care cannot be disclaimed entirely, the parties can by stipulation determine the standards by which those duties are to be measured, so long as such standards are not "manifestly unreasonable." The upshot is that courts retain the power to supervise the parties' stipulations, but parties can through careful planning make it less likely that their choices will be second-guessed in practice.

Because there are so many ways for contracting parties to influence the interpretive regime under which their agreements will be enforced, the existing literature's emphasis on advising public lawmakers whether to restrict or liberalize their interpretive approach is to an significant extent beside the point. The interpretive regime should be understood as a sort of default rule, which parties can opt out of with careful planning. Different parties, depending on their circumstances, will prefer different tradeoffs between form and substance, and helping the parties to choose the correct balance in this regard is one of the main tasks the transactional lawyer faces. Judicial formalism may wax and wane, but this planning problem will remain important for lawyers and for their clients.

C. Motivation for the analysis to follow

What is needed, accordingly, and what the economic analysis of contracts can provide, is a basic taxonomy of substantive considerations that can serve as an organizing framework for parties choosing between form and substance when designing contracts. A good commercial lawyer needs to understand the functional underpinnings of the transaction in order to help plan it — and in commercial settings, these underpinnings are economic. I am not claiming that actual transactional attorneys do not take such considerations into account — of course they do; a working familiarity with such factors is one of their main stocks in trade. But organizing such insights into a more systematic conceptual framework helps us to integrate and synthesize disparate bodies of practical knowledge relating to various commercial and legal fields: negotiable instruments, letters of credit, choice of law, sales, and so on. Such a synthesis enables insights from one field to be translated and analogized for the purposes of critiquing and improving transactional planning in others. Additionally, it serves an important pedagogical function in the training of law students, because young lawyers beginning legal practice will be able to assimilate conventional wisdom more quickly and effectively if they are first equipped with its implicit theoretical underpinnings.

In this essay, therefore, I focus on the question of when and why contracting parties should choose formal methods of interpretation over substantive ones, or vice versa. My analysis thus will implicate questions such as whether the parties should write a merger clause into their agreement or whether the parties should opt into Virginia law, rather than questions such as whether a court should admit a given item of parol evidence, or change its doctrines so as more closely to resemble Virginia law. Of course, if we are able to develop a framework for answering the former set of questions, that will likely help courts to answer the latter set of questions as well, and possibly to ask those questions differently. Instead of

asking what substantive terms the parties intended to have in their agreement, courts might begin to ask what interpretative method the parties wished to have.

But this last question is a tangent, not my main concern. In the succeeding sections of this essay, accordingly, I attempt to catalog the main considerations that ought to influence the parties' decisionmaking regarding form and substance. Section II sets out my basic analytical and normative framework; it defines more precisely what I mean by form and substance, and discusses and critiques a theoretical argument that has been influential in the traditional literature on contract interpretation: namely, the argument that formalist approaches to interpretation are not coherent because all interpretation presumes some common basis of contextual knowledge between speaker and audience, and thus requires attention to the relevant context. Section III then discusses a variety of familiar transactional problems such as costly information, risk allocation, rent-seeking, agency costs, and the protection of relational investments, and explains how these problems relate to the form/substance distinction. Section IV summarizes the analysis and offers conclusions.⁴⁹

II. A model of the choice between form and substance.

A. Normative considerations

In this section I set out my operational definitions of form and substance in the interpretive context, as well as the normative goals that my framework is designed to pursue. The latter question is more quickly addressed. This essay is intended to follow in the tradition of functionalist accounts of formalism such as that of Lon Fuller.⁵⁰ But because I am focusing on those functional considerations that are most relevant to decision-making by contracting parties at the planning stage, my analysis is limited almost exclusively to issues of economic efficiency. Specifically, I concentrate on the question what administrative arrangements will maximize the total expected value of the underlying exchange, with adjustments for risk

49. An additional section, to be added to this essay in a later draft, will discuss whether and to what extent market failures (such as externalities, bounded rationality and the like) or other institutional considerations might justify placing limits on parties' freedom to contract over matters of form and substance.

50. Fuller, *Consideration and Form*, *supra* note x.

aversion but not for distribution or procedural fairness (except insofar as the parties are willing to sacrifice exchange value in order to promote such other goals.)

I defend this focus on pragmatic grounds that are standard in the economic literature on contracts; most importantly for reasons of brevity and specialization of scholarly labor. The normative appeal of the efficiency criterion has been thoroughly discussed by other scholars (indeed, there has been a recent resurgence of debate over the criterion) and I have nothing to add to this discussion at present. Justifying the efficiency criterion as a matter of fundamental principle is beyond the scope of this essay, and the usual admonitions will apply.⁵¹ Second, this essay attempts in particular to develop general principles that can be used to further the aims of private contracting parties. Such parties, especially those operating in the commercial context, generally engage in exchange for instrumental purposes, which typically include the goal of material profit. Any analysis that did not give a central place to maximizing contractual value would not address these needs. Third, as long as the transaction in question is an arms-length one, the parties have the option not to enter into it, and they are informed of the relevant business risks and legal consequences, there are no clear distributional consequences flowing from any change in legal rules.⁵² As a general matter, the surplus from exchange tends to be divided among contracting parties in proportion to their relative eagerness to enter into the bargain. Any efficiency gains or losses resulting from a change in regime, accordingly, will be shared.⁵³

In the bulk of this essay, furthermore, I also treat the interests of the contracting parties as paramount. This approach is equivalent to assuming that there are no important third-party effects attaching to the principal parties' decisions. If there are such third-party effects, then

51. For more general discussions of the efficiency criterion, see Jules Coleman, *MARKETS, MORALS, AND THE LAW* (1988), ch.4 ; Richard Posner, *THE ECONOMICS OF JUSTICE* (1983), chs.3 and 4; and the articles appearing in *Symposium on Efficiency as a Legal Concern*, 8 *HOFSTRA L. REV.* 485–770 (1980). More specifically, Louis Kaplow and Steven Shavell, *Why the Legal System is Less Efficient than the Income Tax in Redistributing Income*, 23 *J. LEGAL STUD.* 667, argue that even if distributional equity is an important social objective, it is more effectively promoted by using direct public instruments such as tax and transfer payments, rather than through the rules of private law. [Also add cite to the recent literature inspired by Kaplow and Shavell, *Fairness Versus Welfare*, __ *Harv. L. Rev.* __ (2001).]

52. The doctrine of silence as acceptance, discussed in Katz, *supra*, note 7, is an exception to this statement because the doctrine influences the cost of declining an exchange.

53. See Richard Craswell, *Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 *STAN. L. REV.* 361–398 (1991).

we can stipulate that from an efficiency standpoint courts and other public officials ought to watch out for them, and ought to refuse to give effect to any contractual provisions — including those that deal with the form/substance issue — that impose negative externalities. In a subsequent version of this essay, I will discuss some of these possible externalities, as well as other contractual failures such as bounded rationality and imperfect information that would justify overriding the parties' contractual freedom, but for the present I will ignore them, for reasons generally analogous to those I have given above for ignoring issues of distribution.

It is worth making one initial remark regarding the relevance to my analysis of the liberal norm of personal autonomy. Some contract scholars, including Randy Barnett, have argued in favor of formalist modes of interpretation on grounds of autonomy, reasoning that clear and predictable rules help to facilitate the free exercise of individual will, and operate as a safeguard against state agents illegitimately infringing on individual choice.⁵⁴ Other autonomy theorists, such as Charles Fried, have instead claimed that deference to parties' freely exercised choices may sometimes require courts to pay closer substantive attention to what choices the parties actually intended to exercise.⁵⁵ I take no position on this controversy, and indeed have little to say about autonomy. It does seem to me, however, that a principled liberal should be in favor of allowing people entering into contracts to choose between formal and substantive modes of contractual interpretation, based on what seem to them to be good and sufficient reasons, unless there is some reason such as force or fraud that justifies overriding the parties' will. In this regard, my goals here are consistent with those of a liberal or libertarian, in that my focus is on clarifying the considerations that would be relevant to such a choice in the individual case. To the extent that the parties' deliberations are well-considered, that offers greater support for respecting their decisions; and so to the extent that my analysis fosters better private decisionmaking, it also forwards liberal values.⁵⁶

54. Cites. See also Ernest Weinrib's more general autonomy-based defense of formalism; cf. G. Brennan & J. Buchanan, *The Reason of Rules* (1985).

55. Fried, *Contract as Promise*, at ___.

56. Compare in this regard the normative tradition of corrective justice, which in some of its versions might be thought to suggest that moral or legal wrongs need to be substantively righted regardless of the wishes and intentions of the victim, and that this obligation is inalienable. While my efficiency-oriented approach is compatible and even consonant with the autonomy norm, it conflicts with the corrective justice approach to this extent. See generally Kaplow and Shavell, *Fairness versus Welfare*, *supra* note x.

B. A descriptive model

With these normative preliminaries out of the way, we are now in a position to turn to the main analysis. There are numerous accounts of the distinction between form and substance in the scholarly literature.⁵⁷ One sees the dichotomy expressed in terms of rules versus standards, rules versus discretion, textual versus contextual modes of interpretation, static versus dynamic interpretation, simplicity versus complexity, determinacy versus flexibility, objective versus subjective standards, and so on. Each of these opposed pairs highlights different functional aspects of the formalism problem, but what they have in common is that the first member of each opposed pair connotes an interpretive approach that focuses on a more limited set of authoritative or evidentiary materials, and the second member connotes an approach that embraces or allows for the consideration of a more expansive set of materials. A rule-based theory of interpretation, for instance, directs the interpreter to limit his or her attention to the specific considerations set out by the lawmaker at the time that the rule was promulgated, while a standard-based theory allows the interpreter also to consider factors that may not become apparent until the moment that law is applied to facts.⁵⁸ Similarly, an objective standard of interpretation directs the interpreter to limit attention to factors that would be accessible to all individuals who can be categorized as being in the relevant agent's position (with the category being defined widely or narrowly depending on the prescriptions of the standard), while a subjective interpretive standard directs the interpreter additionally to consider factors that might be accessible only to the individual parties to the contract.⁵⁹

Following this general distinction, accordingly, in this essay I will model the concept of formality as a function of the set of materials that an interpreter considers in arriving at an interpretation. Formalism entails restriction to a smaller set of decisional materials (for example, the presence or absence of a wax seal, as it relates to the enforceability of a written

57. Here cite, inter alia, Duncan Kennedy, *Form and Substance in Private Law Adjudication*, also *Legal Formality*, Schauer, *Playing by the Rules*, Kaplow, *Rules vs Standards*, the Chicago symposium, Eisenberg, *The Nature of the Common Law*, Scalia, *The Rule of Law as a Law of Rules*, Eskridge, *Dynamic Statutory Interpretation*, Grey, *The New Formalism*.

58. See, e.g., Kaplow, *Rules versus Standards*.

59. See, e.g., Restatement (Second) of Contracts §§10,101 (contrasting objective and subjective interpretive standards, as well as standards emphasizing the alternative interpretive positions of speaker and listener).

promise); while substantive interpretation permits and sometimes directs attention to a larger set of decisional materials (for example, the underlying facts of a business relationship, as they relate to the presence or absence of contractual consideration). I am hoping that this account of formalism will seem both intuitively appealing and familiar; it resembles and draws on, for instance, the concept of exclusionary reasons put forward by jurisprudential writers such as Raz and Schauer.⁶⁰ In order to highlight the connection of my approach with economic analysis in general and decision theory in particular, however, I denote the set of permissible materials associated with a given interpretive regime as the regime's *information set*. Note that my definition of formalism can itself fairly be called formalistic, since it suppresses other factors that some people might consider relevant to an account of the distinction between form and substance.⁶¹

On this definition, it is not possible strictly to rank all interpretive regimes in order of their formality, since the information sets associated with two regimes may overlap. For instance, §2-202 of the Uniform Commercial Code directs courts interpreting an integrated contract to consider trade usage, course of dealing and course of performance in interpreting the meaning of the contract, but not to consider evidence of prior agreements or contemporaneous oral agreements to the extent that they are inconsistent with the written contract terms. The standard for determining inconsistency, however, is not prescribed; and many courts have applied it liberally.⁶² This approach is in contrast with the traditional common law, which took a stricter stand on the admission of parol evidence and did not explicitly confer official status on course of performance. In this regard, the UCC is less formal. But §2-209(2) also provides that if the parties to a signed contract adopt a no-oral-modification clause, attempted oral modifications will be ineffective.⁶³ This device was not

60. See Raz, *The Authority of Law*; Schauer, *Playing by the Rules*.

61. Note also that according to this definition, both traditional legal positivism, which distinguishes between moral and legal considerations and which claims that only the latter provide an appropriate basis for legal decisionmaking, and Ronald Dworkin's contemporary version of positivism in *Taking Rights Seriously*, which distinguishes between considerations of policy and of principle and which claims that only the latter provide an appropriate basis for judicial decisionmaking, are formalist theories.

62. In the spirit of official comment 3, which appears to suggest a presumption of consistency: "If the additional terms are such that, if agreed upon, they would *certainly* have been included in the document in the view of the court, then evidence of their alleged making must be kept from the trier of fact."

63. Although under 2-209(4) they may depending on circumstances operate as a waiver.

recognized at common law, and in this regard the UCC is more formal. Thus, if we are being absolutely precise, only if the information set associated with a given regime is entirely contained within the information set of another regime (i.e., the first information set is a proper subset of the second) can we say that the first regime is strictly more formal than the second. But speaking more casually, it will be useful to call a regime relatively formal if its information set is relatively more restricted than another's, or if its information set contains relatively little that is not contained within the other information set, and omits a significant amount of material that is contained within the other information set.

While the set-theoretic definition I have given may appear to suggest a bright-line distinction between formal and substantive modes of interpretation (because under classical notions of set theory a given element either is or is not a member of a set), it can also be understood in probabilistic terms. Some regimes — indeed, probably most — may admit certain types of material into their permissible information set, but only some of the time, or only for limited purposes, or with less weight, or only if the material is weighty enough to overcome a presumption against admissibility. Accordingly, a regime that allows the consideration of more interpretive material more of the time or with greater probability is more formalistic, other things being equal, than a regime that uses such material less of the time or with lower probability. Similarly, a regime that establishes a hierarchy of influence and that treats certain types of material as more weighty or more privileged than others is more formalistic than one that accords all types of material equal consideration. To illustrate, under the Second Restatement's approach to the parol evidence rule, the court may consider parol evidence for the purpose of deciding whether the written contract is an integrated one or not. If the court decides on the basis of the evidence that the writing is an integration, then the parol evidence is not supposed to be used to interpret the writing further, and must be withheld from the trier of fact. Similarly, under §2-208 of the UCC, factfinders are directed to interpret trade usage, course of dealing, course of performance, and express contractual terms as consistent with one another if they can reasonably bear such a reading, if they cannot, express terms are to take precedence over the other categories of material, course of performance is to take precedence over trade usage and course of dealing, and course of dealing is to take precedence over trade usage.

It is important to note that the information set associated with a given interpretive regime is not the same thing as the information set that is actually used by any particular interpretive agent within that regime when making an interpretive determination — and similarly, that this latter information set (call it the *agent-specific information set*) may vary among agents

within the same regime. In this case, the effective formality of a regime will depend on the distribution of information sets across all agents within it, and as such must be understood in statistical terms. For example, a given regime might permit individual judges to make use of their experience in previous cases when making an interpretive decision, or might allow courts to take judicial notice of particular facts. Under that regime, judges with different backgrounds or levels of experience would have different agent-specific information sets available when making their decisions. A regime that prohibited discouraged judges from considering this sort of background information would make their individual agent-specific information sets more similar. If we compare the information available to judges to the information available to contracting parties, however, a ban on judicial notice could make the *expected information set*, as averaged over the set of all judges, either more or less similar to the expected information set, as averaged over the set of all contracting parties. The direction of the outcome would depend on how much the experience of judges overlapped with the experience of contracting parties.

Accordingly, the effective degree of formalism achieved by the regime should be understood as a function of its agent-specific information sets, each of which are themselves functions of the regime's general information set. Within this theoretical framework, contracting parties can opt into a more formal interpretive regime in two ways: first, by placing limits on the overall information set permitted by the regime (for example, by excluding parol evidence or evidence of oral modifications), and second, by limiting the set of eligible interpretive agents (for example, with a choice-of-forum or arbitration clause.)

C. The contextualist argument

This way of framing the problem helps to rebut a common argument against using formal methods of interpretation, to the effect that all interpretation depends upon a common basis of contextual knowledge between speaker and audience and that formalism mistakenly supposes that this is not the case. The argument typically goes as follows: as a matter of social practice, words have no fixed or plain meaning, and communications are not self-executing. A tribunal faced with a communicative text of potentially legal significance must always make a contextual interpretation, based on its experience, on its stereotypes about parties such as these and their likely purposes, and on the linguistic conventions it regularly participates in and that it thinks the parties participate in. As the legal-and-literary critic

Stanley Fish has put it, “you can never not be in a context.”⁶⁴ Accordingly, if the tribunal interprets a contract formally — that is, without fully inquiring into the actual context out of which it arose, there is no guarantee that it will apply the contract as the parties subjectively intended. The parties may have meant “chicken” to mean “broiler chicken,” they may have meant “minimum quantity” to mean “at buyer’s option,” they may even have intended “buy” to mean “sell”; and one can’t know for sure without inquiring. If the court doesn’t inquire, it is interpreting by its own lights, not the parties’. The choice for the court, therefore, is not whether to rely on context and substance, but which context and substance to rely on: the parties’, or its own.

This argument — call it the *contextualist argument* — has been very influential in the contracts literature in the last fifty years; its advocates have included such luminaries as Wigmore⁶⁵, Corbin⁶⁶, and Justice Traynor.⁶⁷ In its claim that all interpretation requires some

64. From *Is There A Text in This Class? The Authority of Interpretive Communities* (1980), at x. See also Stanley E. Fish, *Normal Circumstances, Literal Language, Direct Speech Acts, the Ordinary, the Everyday, the Obvious, What Goes without Saying, and Other Special Cases*, 4 *Critical Inquiry* 625 (1978) (“A sentence is never not in a context, We are never not in a situation. . . . A set of interpretive assumptions is always in force. A sentence that seems to need no interpretation is a ready product of one.”).

65. The fallacy [of plain meaning] consists in assuming that there is or ever can be some one real or absolute meaning.”⁹ Wigmore, *Evidence* § 2462 (Chadbourn rev. 1981). Cited in *Steuart v. McChesney*, 498 Pa. 45 (1982), at 49.

66. [S]ome of the surrounding circumstances always must be known before the meaning of the words can be plain and clear; and proof of the circumstances may make a meaning plain and clear when in the absence of such proof some other meaning may also have seemed plain and clear.” 3 Corbin, *Contracts* § 542 (1960). Cited in *Steuart v. McChesney*, 498 Pa. 45 (1982), at 49. See also *Restatement (Second) of Contracts* § 212, comment b: “It is sometimes said that extrinsic evidence cannot change the plain meaning of a writing, but meaning can almost never be plain except in a context. Accordingly, the rule stated in Subsection (1) is not limited to cases where it is determined that the language used is ambiguous. Any determination of meaning or ambiguity should only be made in the light of the relevant evidence of the situation and relations of the parties, the subject matter of the transaction, preliminary negotiations and statements made therein, usages of trade, and the course of dealing between the parties.”

67. “A rule that would limit the determination of the meaning of a written instrument to its four-corners merely because it seems to the court to be clear and unambiguous, would either deny the relevance of the intention of the parties or presuppose a degree of verbal precision and stability our language has not attained.” *Pacific Gas & Electric Co. v. G. W. Thomas Drayage & Rigging Co.*, 69 Cal. 2d 33, 442 P2 641 (1968). “Words are used in an endless variety of contexts. Their meaning is not subsequently attached to them by the reader but is formulated by the writer and can only be found by interpretation in

context, it seems plainly right. Where the argument goes wrong, however, is in assuming that this claim, together with the goal of carrying out the parties' intentions, commits one to a substantive approach to interpretation, because this conclusion does not follow. As Eric Posner has observed, the assumption neglects the possibility that the parties can have intentions regarding how their intentions are to be interpreted.⁶⁸

Translated into the framework of our model, the contextualist argument simply states that interpretation is always carried out with reference to a particular information set. A tribunal's information set is made up of various elements including the judges' experience and training, the text of the contractual agreement, as well as any additional material presented by the parties in litigation. Given its information set, the court can carry out its interpretation with the goal of forwarding the intentions of the parties, or it can pursue some other goal, such as forwarding its own view of the best social policy. Whatever goal the court pursues, however, it must make its best guess based on the information available to it. While the quality of the guess, in a statistical sense, depends on the available information set, which information set to use and which goal to pursue are independent questions. A broad information set can be used to pursue goals other than the fulfillment of the parties' intentions; and a narrow information set can be used to pursue the parties' intentions, however roughly.

This translation suggests that not only does the contextualist argument not prove that plain meaning is incoherent, it actually provides us with an operational definition of plain meaning, and an economic one at that. Namely, for a given audience or interpreter, plain meaning corresponds to the interpretation associated with the interpreter's ordinary or zero-cost context — that is the context that the interpreter can apply with minimal work. Under more substantive interpretative doctrines, the tribunal deliberately seeks out an augmented context. Under more formalist interpretive doctrines, the tribunal deliberately restricts its context. What meaning is plain, furthermore, will be agent-specific and context-specific. If I make a pun or employ irony, for instance, my plain meaning will be one thing to an audience that catches the irony and another to one that doesn't.

the light of all the circumstances that reveal the sense in which the writer used the words. The exclusion of parol evidence regarding such circumstances merely because the words do not appear ambiguous to the reader can easily lead to the attribution to a written instrument of a meaning that was never intended." *Universal Sales Corp. v. California Press Mfg. Co.*, 20 Cal. 2d 751 (1942) (concurring opinion);

68. E. Posner, *The Parol Evidence Rule*, *supra*, at _.

Note that according to this definition, plain meaning is not the most formalistic interpretive mode possible. The tribunal can ignore or throw away information that is part of its ordinary context, as when a court applying constitutional rules of criminal procedure deliberately excludes evidence that is the fruit of an illegal search or coerced confession. Because some effort is involved in the exclusion, however, it only makes sense to do this if there is some cost associated with using the excluded information.

The same analysis holds, by the way, for all types of interpretation. If I plan to attend a Shakespearean play, for instance, I could read the play in advance so as not to miss intricacies of language that would not otherwise be familiar to me, or I could just go unprepared and enjoy the play as best as I can. If I do read the play in advance, I could buy the pocket book version, which is cheaper and easier to carry around on the subway, or I could at somewhat greater cost buy and read the annotated edition. I could read the introductory essays in that edition, or not; I could go to the library and read secondary literature or do historical research; or I could go to graduate school and get a Ph.D. in English. Assuming I know of the existence of the annotated edition, the secondary literature, and the available graduate programs, however, my choice is a deliberate and informed one, influenced by the relative costs and benefits of the alternatives.

Conversely, creators of communicative texts also make choices about how much context to provide, and this choice is also influenced by the costs and benefits. An author could spell out additional meaning in a fuller and longer text. This will increase printing and shipping costs of printing as well as the time required for reading; and will also tend to reduce spontaneity and creative experience for the reader. Thus in literary (and especially poetic) communications this is not usually done, but it can be (consider T. S. Eliot's *The Wasteland*, with its extensive annotations.) The same is true in music, painting, arts, letters, and law. The decision whether to provide more context, however, depends on purposes of the interpretation — or in economic terms, the marginal costs and benefits of context.

The trick is to identify the relevant costs and benefits and how to trade them off against each other. In the example of the Shakespearean play, for instance, the tradeoff is relatively straightforward: more time and effort versus a deeper enjoyment of the play. Furthermore, since both the costs and benefits accrue to me personally, there is little reason not to let me decide how I wish (putting aside paternalistic situations such as high school English class). In cases, where contracts and other texts of legal significance are being interpreted, however, the problem is more complicated, and the costs and benefits are more varied. For example,

errors in determining whether or not one party owed another a legal duty or whether such a duty was breached can undercut incentives to comply with such duties.⁶⁹ Errors in determining the standard of care implied by a legal duty, the amount of care that the parties actually took in their particular case, or the damages resulting from a breach of duty can encourage either inadequate or excessive caretaking.⁷⁰ In the contractual setting, the parties are also interested in incentives for information exchange and for investment in the relationship.

In summary, the problem of form versus substance in contract interpretation can be assimilated to the problem of optimal information acquisition. From an economic viewpoint, a fuller or broader context can be purchased, but only at a cost of time and trouble, and of exacerbating certain incentive problems, so it pays to stop at some optimal point. The next section of this essay surveys the main types of considerations that determine the costs and benefits of formalism, and thus the optimal stopping point.

III. Choosing between form and substance: a survey of economic criteria

The standards for measuring contractual liability and damages for breach influence contracting parties' behavior in many respects: with regard to decisions to breach, to take advance precautions, to mitigate damages, to gather and communicate information, to allocate risk, to make reliance investments, to behave opportunistically, to spend resources in litigation, and so on. The regime of contract interpretation, because it determines how liability and damages will be assessed ex post, has similarly widespread incentive and efficiency effects. Accordingly, given the purposes for which I am writing, it does not make sense to try to develop a unitary theory for choosing between form and substance, since the answer in any particular case will turn on a comparison of various types of transaction costs. Instead, I will list and discuss the main categories of these transaction costs, with the hope

69. See Kaplow and Shavell, Accuracy in the Assessment of Liability, 37 *Journal of Law and Economics* 1 (1994).

70. See Craswell and Calfee, Deterrence and Uncertain Legal Standards, 2 *J. Law Econ. & Org.* 279 (1986); Kaplow and Shavell, Accuracy in the Assessment of Damages, 39 *J. Law. Econ.* 191 (1996).

that a systematic consideration of these issues will help individual parties address the formality problem in specific contexts.

A. Direct transaction costs

The most obvious consideration is the direct cost of writing contracts and litigating contractual disputes, and these costs can be affected in various ways by formality. Other things being equal, an agent that bases its interpretive decisions on a smaller set of materials should, whether it is performing or enforcing a contract, require less time and effort to carry out its task. Thus, formal modes of interpretation will be appropriate whenever the ex post costs of time and effort are especially large — for example, when time is of the essence or when the opportunity costs of the enforcing or performing agent's time is high. Thus, in letter of credit transactions, where the viability of the letter of credit as a payment device depends on the speed and administrative efficiency with which payment can be processed, formal methods of interpretation are favored.⁷¹ Issuing banks are not supposed to look past the face of submitted documents when determining whether documentary conditions have been satisfied, and the rules for determining compliance with such conditions is strict. Similarly, in markets where a high level of trust among the participants is necessary to support cooperation with regard to the performance of non-verifiable aspects of the contract, and where extended disputes can undermine such trust, disputes can be kept short and relatively painless through the application of relatively formal decision procedures.⁷²

It should be recognized, however, that if the contracting parties anticipate that formal decision procedures will be applied at the performance or enforcement stage, they may be induced to put greater effort into specifying additional considerations or supplying additional interpretive materials at the contract-writing stage, in order to address some of the issues that are discussed below, such risk or performance incentives. For example, the anticipation that issuing banks will not look beneath the surface of any supporting documents when processing a letter of credit may induce the issuer to provide a more elaborate set of documentary conditions up front. (Conversely, the prospect that any such conditions will be enforced strictly may induce parties to provide a less elaborate list of requirements.) If this effect is a

71. Cite Dolan on letters of credit on this point.

72. E.g., Bernstein on trust relations in the uncut diamonds market.

significant one, then the cost of considering additional interpretive materials *ex post* needs to be weighed against the costs of increased contract-writing costs *ex ante*.

B. Risk

Variation in interpretive outcomes introduces risk into the contractual relationship. Since contracting parties usually dislike risk and are willing to expend resources to avoid it, they may choose between form and substance as a risk management device. The choice will be different, however, for parties with different attitudes toward risk or different abilities to spread or diversify it. In the interpretive setting, outcome risk derives from variations in the distribution of agent-specific information sets. A widely dispersed distribution of information sets means that factfinders or performers will interpret the same materials differently. To the extent that adding additional interpretive material reduces this variation, it will reduce the resultant interpretation risk.

For instance, suppose that judges vary in their background experience with regard to commercial matters. They will accordingly differ in their reading of particular documents, or of legal standards such as reasonableness or good faith. If the judges are directed to inquire more deeply into the commercial context before deciding on their interpretation, this inquiry will (at a cost) reduce variance by making the less experienced judges' information sets more closely resemble the more experienced judges' information sets. (One might speculate that differences in perspective will lead the experienced judges to evaluate the new material differently, thus increasing the interpretive variance rather than decreasing it, but such an outcome is unlikely so long as there are diminishing returns to expertise, or so long as the variations in judges' evaluation of individual items of interpretive material are less than fully correlated, so that expanding the basis of decision will reduce total variance through diversification and the law of large numbers.)

The value of risk reduction may help to explain Lisa Bernstein's observation that industry tribunals tend to follow relatively formal regimes of interpretation, even though their cost of inquiring into substance is relatively less than that of generalist judges. To the extent that the judges are already expert in the subject of the contract, the variance among their information sets is likely to be low. Thus the marginal value of risk reduction that is purchased by the consideration of additional information is likely to be smaller, and less likely to justify incurring the additional costs. The fact that contracting parties in such settings prefer relatively formal rules when litigating in front of expert tribunals, accordingly, does not imply

that they would have a similar preference when litigating in front of generalist judges and juries.

Additionally, to the extent that substantive interpretation reduces the variance of interpretive outcomes, it is more valuable to relatively risk-averse parties, other things being equal. Conversely, contracting parties who are less risk-averse or who have other methods of risk reduction available to them should be less willing to incur the costs of substantive interpretation. This latter category includes larger or more diversified businesses and other contractual repeat players, who can diversify interpretation risk over a greater number of transactions, as well as agents such as middlemen who are likely to be on both the buying and selling side of transactions with equal frequency. The risk factor thus provides additional explanation why such actors tend to use standard forms, in addition to the more obvious reason of economies of scale.

C. Performance incentives

Variation in interpretive outcome is not just a matter of risk, of course, because the parties' anticipation of what enforcers will do can affect their incentive to perform their contractual duties. For instance, legal error in assessing contractual damages following breach may induce either inefficient performance (if the tribunal tends to overestimate damages *ex post*) or inefficient breach (if the tribunal tends to underestimate damages *ex post*). Variations in the assessment of substantive duties may have similar effects. For instance, if the tribunal tends to overestimate (underestimate) the promised level of product quality by reading an express or implied warranty more broadly (narrowly) than the parties intended, this may induce the seller to provide too much (little) quality from an efficiency point of view. The distributional consequences of these sorts of errors can be priced out on average, but the efficiency consequences may remain. Lower variance in interpretive outcome, accordingly, can provide the parties with more precise performance incentives.

The value of such increased precision, however, depends upon the parties' circumstances, including the information available to them at the time they make performance or precaution decisions and their ability to renegotiate the contract *ex post*. The fact that tribunals vary in their potential assessments of damages, for example, should not lead to inefficient breach or performance so long as the assessment is correct on average, since the contracting parties are unlikely to know the particular characteristics of their tribunal at the time they have to decide whether to perform. In making their decisions, they will be in a position of uncertainty and

will only be able to compare the costs of performances against the expected costs of paying damages for breach, averaged over the set of all potential tribunals. A reduction in the tribunal's variance, accordingly, does not purchase any efficiency gains up front, so long as the parties are not risk-averse.

On the other hand, if parties do have information about the likely direction of tribunal error at the relevant time of decisionmaking, their incentives to perform or take precautions against breach will be inefficient. For instance, suppose that a sales contract contains a clause that requires the seller to deliver goods by June 1, but the parties as a matter of trade usage understand the delivery date to be interpreted flexibly, and in their understanding the seller has the option to deliver as late as June 15 if market conditions make it unduly expensive to meet the June 1 date. If not all courts would recognize this implicit understanding absent an inquiry into the commercial context, a seller who does not meet the June 1 date will expect to be found in breach of contract with some positive probability. Depending on the damages that might be assessed and the expected costs of any litigation, accordingly, he might be led to take inefficiently costly precautions to guard against late delivery. If the inefficiency losses are high enough, it would be worth directing courts to inquire into trade usage before finding any liability.⁷³

The extent of these inefficiency losses, however, depends on the ex post costs of disputing and renegotiation. Just because the original contract does not provide efficient incentives for performance does not mean that an efficient outcome will result, because the parties can modify the contract after the fact to reach an efficient result. This renegotiation may entail an additional payment from one of the parties to another, but the expected cost of this payment can be calculated up front and included in the original contract price.⁷⁴

Parties with relatively low ex post renegotiation costs, accordingly, should tend to favor formalistic methods of interpretation, other things being equal. This category includes parties

73. They could also write their trade usage explicitly into the contract, but this has transaction costs of its own and is likely to be cost-justified only for usages that are unfamiliar to a sufficient number of courts, or that govern contingencies that are especially likely to arise. If the contingency in which trade usage becomes relevant is a sufficiently long one, or if the likelihood of a given court being unfamiliar with it ex post is low, then it will be cheaper for the parties to remain silent and to take the risk of an incorrect interpretation.

74. See Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 *Southern California Law Review*, 629-670 (1988).

who anticipate a continuing relationship, parties who engage in many similar transactions or do business together regularly, and parties who expect to have symmetric information ex post regarding the costs and benefits of performance. Parties for whom the transaction is an unusual one, parties in one-shot contracts, and parties who expect there to be asymmetric information ex post should tend to favor more substantive methods of interpretation as a substitute for their own ability to bargain to an efficient outcome.⁷⁵ Similarly, parties who have available to them other methods of ensuring efficient performance, such as nonlegal or reputational sanctions administered through membership in a commercial subcommunity, are less likely to want to incur the expenses of substantive interpretation, and other things being equal should prefer a formalist approach.

D. Reliance incentives

Much of the economics-of-contracts literature has emphasized the role of contractual liability in promoting investment in relationship-specific assets. Absent legal protection for such investments, rational contracting parties will underinvest in them from the efficiency viewpoint, for fear of losing some or all of their value in an ex post hold-up. The standard intuition here is that because the asset is worth little outside the specific relationship, the party who invests in it becomes vulnerable to threats to terminate the relationship. Such threats provide the non-investing party with the bargaining power to obtain a unilaterally favorable modification. But investors' ability to anticipate such opportunism reduces their incentive to make such investments in the first place. In contrast to the problem of inefficient performance and breach, ex post renegotiation cannot address this efficiency problem, since it is precisely the prospect of such renegotiation that creates the threat of hold-up.⁷⁶ It can only guarantee that whatever investments are made are put to efficient use.

75. Compare Jason Johnston's argument in *Bargaining Under Rules Versus Standards*, 11 *Journal of Law, Economics, and Organization* 256 (1995) that legal regimes that use standards to determine liability do a better job at encouraging bargaining under asymmetric information than regimes that use rules.

76. See generally Benjamin Klein, Robert Crawford, and Armen Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 *J. Law & Econ.* 297-326 (1978) (specific investments determine appropriate scope for vertical integration of the firm); Oliver Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 *J. Law & Econ.* 2-61 (1979) (discussion of specific investments as a type of transaction cost).

The need to encourage specific investments will influence the form/substance decision whenever the value of the investment turns on the nature of contractual interpretation. Many investments, even if they are relationship-specific, will not depend on interpretation in this way. For example, suppose that a supplier of complex industrial machinery must invest substantial time and effort acquiring expertise about the specific production process of a particular customer. This expertise is only partially transferable to relationships with other customers and is thus relationship-specific; and so in order to be induced to acquire it, the supplier must be persuaded that a relationship with this particular customer is in the offing. An important way to commit to such relationship is through a binding contractual promise. However, the value of supplier's investment in expertise need not turn on the specific content of the contract; it may be that knowing the customer's needs reduces the cost of providing the customer with machinery of all sorts. In this case, the supplier need not worry about unexpected contractual interpretations that leave the basic contract in place (for example, requiring the delivery of a machine with this set of characteristics rather than that), since its investment in expertise is equally sunk with all interpretations. The possible variation in contract requirement does involve some risk, of course, but this can be priced out or dealt with using the other methods described above.

On the other hand, there are some investments whose value turns on the specifics of the task to be performed. A supplier who contracts to supply goods within a narrow time window may need to take special precautions in storing inventory and arranging for timely shipment; it may conversely fail to invest in facilities that would provide it with greater flexibility to deliver outside the window. If the contract is subsequently interpreted to provide the customer with greater discretion in specifying the time of delivery, the supplier can become vulnerable to holdup; it may have to agree to a substantial reduction in price in order to induce the buyer to take delivery during the originally anticipated window. (Conversely, if the contract is interpreted to require delivery within a window when one or both of the parties understood the window to be more flexible, the party who is caught short may have to pay a substantial ransom in exchange for being released from this unanticipated obligation.) A second example is provided by the case of a supplier who promises to supply finely milled machine parts of a particular specification. If the contract is interpreted to allow the buyer more leeway to alter the specifications (or conversely, to insist on strict rather than substantive compliance with the specifications), then the supplier will be relatively vulnerable to holdup if its retooling costs are large, but relatively invulnerable to holdup if its retooling costs are small.

To the extent that a substantive interpretive approach improves the quality of the enforcing tribunal's estimate of the parties' expectations (that is, to the extent that it reduces the expected difference between the interpretive outcomes *ex post* and the parties' interpretations at the time they must sink their specific investments), it will reduce the potential for such holdups. Parties who find it relatively important to undertake interpretation-specific investments, or whose investments are especially vulnerable to changes in contractual interpretation, will therefore be more likely to want to opt into regimes of substantive interpretation, other things being equal. Parties who do not need to make such investments, or whose investments are more flexible, or who have other methods at their disposal for dealing with contractual opportunism, will have less need for interpretive accuracy and should tend to prefer relatively formalist regimes.

E. Rent seeking

The discussion so far presumes that the costs of writing and litigating contracts is exogenous to the parties' behavior, but more generally this is not the case. Depending on the legal regime, the parties can do various things *ex ante* or *ex post* to turn the bargain in their favor. Under a regime of substantive interpretation, for instance, parties may be tempted to invest substantial resources in litigation in order to maximize the chance of a favorable outcome. From the point of the contracting parties together, such behavior is wasteful, except to the extent that it improves incentives for primary behavior. From the point of view of litigants *ex post*, however, it is individually rational even if there is no such incentive effect.

Formality, by limiting the scope for *ex post* interpretive disputes, probably reduces the marginal productivity of litigation expenditure, and thus reduces the amount of such expenditure. To the extent that it conditions the outcome of litigation on publicly available information, and reduces the variations of litigants' expectations regarding that outcome, it probably also encourages settlement.

On the other hand, rent-seeking can take place at the contract-writing stage as well. For example, I have argued that one cost of enforcing standard form contracts according to the plain meaning of their written provisions is that those who write such contracts will be

tempted to sneak one-sided but inefficient terms into the fine print.⁷⁷ Non-drafting parties will generally not find it worthwhile to examine standard forms with the care required to unearth such self-serving terms, so they are likely instead to assume that such terms have been included and discount the price they are willing to pay accordingly. (Even if parties do examine the standard forms of their contractual partners, conversely, such an examination is costly.) Accordingly, both parties would find it useful to have a way of committing not to engage in such behavior, and an interpretive regime that de-emphasizes the text of the agreement in favor of less manipulable considerations such as market expectations may provide such a commitment device.

But there is, at least in theory, a similar risk of such manipulation with regard to contextual materials such as parol evidence. Just as parties may be tempted to sneak self-serving terms into the contractual text under a formalist interpretive regime, they may be tempted to fill the negotiating history with self-serving proposals and offers under a more substantive interpretive regime, in the hopes of influencing the ultimate result.⁷⁸ I am inclined to regard this latter risk as relatively less important, since in most cases the parties will have more symmetric and effective access to their common negotiating history than they will to each others' standard forms. Blatantly self-serving attempts to manipulate parol evidence are more likely to be observed and parried during negotiations, while self-serving form terms are more likely to escape notice until the contingencies they relate to have materialized.⁷⁹ Still, there is a theoretical tradeoff, so contracting parties concerned about such rent-seeking will want to choose between relatively formal and relatively substantive interpretive regimes depending upon whether they believe rent-seeking is a more significant problem *ex ante* or *ex post*, and whether it is a more significant problem with respect to contractual text than with regard to context. Certain types of contextual evidence may be more or less subject to such

77. See Katz, *The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation*, 89 *Michigan Law Review* 215 (1990), at ___; Katz, *Your Terms or Mine: The Duty to Read the Fine Print in Contracts*, 21 *Rand J. Econ.* 518 (1990).

78. Eric Posner offers this risk as a possible reason in favor of a relatively formalistic parol evidence rule. See E. Posner, *The Parol Evidence Rule*, *supra*. Compare the analogous arguments that advocates of strict statutory construction have made with respect to incentives to create self-serving legislative history. [Cites.]

79. Again, this may be a contrast with the case of using legislative history in statutory interpretation, since relevant actors may find it easier to introduce self-serving statements into the official record without being noticed by their political adversaries.

manipulation; for instance, trade usage seems fairly immune to rent-seeking ex ante, since no individual agent is in a position to have a significant effect on it. On the other hand, to the extent that usage is diffuse and there is room to argue about its substantive content, it is relatively susceptible to rent-seeking ex post. The restrictions on the admissibility of trade usage provided by UCC 1-205(6) may thus be viewed as a way to lessen the rent-seeking costs associated with this type of evidence.

F. Agency problems

Another commonly cited reason for privileging textual over contextual material when interpreting contracts is the need to control the behavior of imperfectly loyal agents. Here it is worth distinguishing between two kinds of agency problems: problems in controlling the behavior of enforcing agents ex post, and problems in controlling the behavior of contracting agents ex ante.

1. Controlling enforcing agents ex post. — While implementing the parties' intentions of the contracting parties is a major and perhaps primary consideration courts' interpretation of their agreements, it is far from the only factor. Courts and other tribunals may be tempted to tailor their interpretations, if only marginally, in the furtherance of other goals such as distributional equity, risk sharing ex post, or corrective justice, as the tribunals see them. Since none of these goals are in the ex ante interests of the contracting parties, the parties would like to arrange the interpretive process so as to minimize the influence of such considerations, to the extent that they can do so at reasonable cost.

One obvious way to do this is to choose in advance a tribunal that is expected to give greater weight to the expected value of the contract, and lesser value to the tribunal's own countervailing values. Choice of law and especially arbitration clauses are straightforward ways of implementing such a choice. But it has often been suggested that restricting the scope of admissible interpretive materials has a similar constraining effect.

Whether this is the case is not clear and depends on a closer study of the particular agent in question and the professional community to whom the agent looks for validation. Certainly, the expansion of the informational universe provides additional opportunities for a court seeking to promote its own values to find justification for its actions.⁸⁰ But a court

80. A possible example of this phenomenon may be found in *Nanakuli Paving and Rock Co. v. Shell Oil*, 664 F.2d 772 (9th Cir. 1981), in which the court directed the admission before a local jury of trade usage

bent on ignoring the parties' intentions in favor of its own policy values also has substantial freedom to do so under a more formal interpretive regime.⁸¹

2. Controlling contracting agents *ex ante*. — Many contracting parties are not individuals, but organizations who can only act through individual agents. Because the incentives of the agents are imperfectly aligned with those of the organization, agents may not behave in a value-maximizing way when entering into a contract or engaging in actions that may affect contractual terms. For example, an insurance agent may make inaccurate representations about policy coverage or about an applicant's insurability in order to earn a commission, or a manager charged with supervising a supplier's obligations may shirk by failing to object to defective performance, thus providing the supplier with a plausible claim of waiver.

In such contexts, formalism can be used by one group of organizational actors to disable other actors from binding the organization on terms that might be in the latter actors' private interests, but not the interests of the organization.⁸² Merger clauses, for example, can be used to take contracting power away from the sales and purchasing agents who orally represent the organization in its dealings with outsiders, and to consolidate that power in the managers and legal professionals who control the official texts of company documents. Similarly, anti-waiver clauses can be used to protect an organization against shirking by its enforcement agents.

evidence purporting to show that Shell had promised Nanakuli, a small local paving company to whom Shell was selling asphalt, that it would protect Nanakuli against any price increases that came after the placing of Nanakuli's order and before delivery, notwithstanding a written contract term providing that the price would be Shell's "posted price at the time of delivery," and notwithstanding the command of UCC 1-205 that when express terms and trade usage cannot be read together consistently, express terms control contractual meaning.

81. Provide example here. Poel? *Raffles v Wichelhaus*?

82. See, e.g., Kevin Davis, *Licensing Lies: Merger Clauses, the Parol Evidence Rule and Pre-contractual Misrepresentations*, 33 *Val. U. L. Rev.* 485 (1999) (arguing that in the interests of minimizing agency costs, sophisticated commercial parties should be allowed to disclaim liability for their agents' extra-contractual representations); Eric A. Posner, *The Parol Evidence Rule, the Plain Meaning Rule, and the Principles of Contractual Interpretation*, 146 *U. Pa. L. Rev.* 533 (1998) (suggesting that rational firms consider the costs of shirking by agents when adopting merger clauses); Katz, *On the Use of Practitioner Surveys in Commercial Law Research: Comments on Daniel Keating's 'Exploring the Battle of the Forms in Action'*, 98 *Mich. L. Rev.* 2760, 2768-70 (2000) (offering agency-cost interpretation of the battle of the forms).

It is important to recognize, however, that the individuals who control the formal text of an organization's contractual agreement are no less agents than those who control the less formal context. Most commercial form contracts are drafted by lawyers, either in-house or not, whose compensation structure provides them with incentives that are not identical or even proportional to the benefits and costs to the firm that employs them. For example, a company lawyer charged with drafting terms in a standard form is probably more likely to be punished for omitting a term that turns out to lead in some remote contingency to a loss for the firm, than he or she is to be rewarded for the time saved by the omission in the far more probable event that the term is unnecessary. The asymmetric nature of the payoff will lead the lawyer to overdraft the contract. Similarly, the lawyer is unlikely to be rewarded for creating terms that increase the value of the contract to the organization's customers or, if he or she works in isolation from the sales department, even to know what such terms might be.

For that reason, he or she will likely draft terms that are inefficiently favorable to the organization from a business viewpoint, that is, which shift risks and duties to customers that are more efficiently borne by the lawyer's organization. Adjusting the contract so that it better fits the needs of the customer and makes him or her willing to buy, accordingly, is a task usually left to the sales agents of the firm.

Thus, an organization should favor formal over substantive methods of interpretation if it has established relatively efficient incentive structures for controlling the behavior of its legal department, and relatively inefficient incentive structures for controlling the behavior of its sales and purchasing departments. If the agency problems are greater with respect to the organization's lawyers, conversely, it should prefer a less formal interpretive regime. The optimal choice may depend on the administrative tools available, and on other agency problems that the organization faces. For example, due to difficulties in monitoring the effort level of sales agents, it may be desirable to give them high-powered incentives by providing the bulk of their compensation in the form of commissions. Given the incentives set up by the commission system, it may then make sense to limit the sales staff's ability to vary contract terms by use of standard forms including a merger clause, especially if the lawyer's compensation is reasonably well tied to the overall profits of the firm. On the other hand, if it is feasible to establish a chargeback system whereby sales agents' earnings are reduced in an amount proportional to the number of disputes arising out of their sales, or by the extra costs necessary to service the special terms promised to their customers, and if the lawyer drafting the contract is an independent contractor rather than an ongoing member of the

organization, then the sales agents may be in a better position to balance the costs and benefits to the organization when making informal promises and representations.

G. Liquidity and the cost of other complementary services

Finally, the optimal choice between form and substance may depend on the importance of third-party contributions to the value of the contract. For example, a buyer of commercial machinery may need to borrow funds in order to pay for its purchase, and will usually be able to borrow at a lower rate if it pledges the machinery as collateral. Similarly, a seller of consumer goods will be able to make credit sales at a lower price if it can sell its customer accounts to a commercial factor, who specializes in buying such accounts and can service them and bear default risk at a lower cost. Another example would be a buyer who purchases two specialized pieces of equipment from two different suppliers, when the two items are intended to be used together; in this case the terms of the buyer's arrangement with one supplier (e.g., terms granting the supplier the discretion to alter the specifications) will affect the terms it can get from the other supplier.

In such cases, the third party's ability to provide such complementary services at low cost will depend in part on the cost it faces when determining the terms of the supported contract. If a factor has to worry about an account debtor asserting defenses when it comes time to collect on the account, the amount it is willing to lend against the account will be reduced accordingly. If the factor can effectively assess the risk of such defenses from an examination of the underlying contract's text, however, it can price the risk out, hold back an amount in reserve that corresponds to the expected value of uncollectible accounts, and lend the balance. If the existence of such defenses depends upon more contextual factors, such as oral communications between the account debtor and the seller's sales agents, the factor will need to be more conservative and will not be able to lend at the same rate or in the same amount. Casting the account in the form of a negotiable instrument, however, or including a holder-in-due course clause in the original sales agreement, lowers the factor's costs by reducing the risk of nonpayment resulting from a cause that the factor could not assess *ex ante*. Other formal devices, including merger clauses, anti-waiver clauses, and the like, similarly lower the costs to third parties of providing supporting services, and thus enable those parties to provide the services at lower cost.

In general, contracts whose value depends significantly on the participation of or the purchase of complementary services from third parties will have higher value when interpreted under a relatively formalistic regime, other things being equal. But this conclusion need not always hold. In some cases, the relevant third party may face higher costs when assessing contractual text than when assessing contextual factors such as trade usage. If the third party is not a legal specialist, for example, as in the case of a third-party guaranty supplied by a friend or family member of the primary obligor, or in the case of a trade creditor who finds it cheaper to observe the parties' ordinary business actions and informal commercial reputations than to examine the details of their written contract, then a more substantive approach to interpretation will protect the third party at lower cost, and thus will make him or her willing to provide the complementary services on more favorable terms.

IV. Conclusion

Interpretation is an essential aspect of all fields of law — statutory, common-law, and constitutional — but it looms especially large in the area of contracts. This is so for two interrelated reasons. First, from an *ex post* perspective, judicial officials called on to enforce an asserted private agreement as law face special difficulties in determining whether the agreement was actually established, what obligations it provides, and what to do if the agreement's terms appear incomplete, ambiguous, or contradictory. Contractual lawmaking is typically decentralized, acts of legal significance commonly take place in private, the participants are often legal amateurs, and their purposes and methods of communication are highly varied. In contrast to a professional legislature with its public records and voting procedures, or a court with its official rulings and published opinions, individual contracting parties can regard themselves as having created legal obligations over a period of time without being able to identify the precise moment at which such obligations came into force. It should be no surprise that disagreements over interpretation are a primary cause of litigated contract disputes.

Second, from an *ex ante* perspective, contracting parties have substantial leeway to influence subsequent interpretation by the manner in which they conclude their agreement. They can take more or less care to identify their underlying assumptions and to communicate their intentions to each other; they can anticipate possible interpretative disputes and settle them in advance; and they can create and preserve evidence of their understandings through

the use of writings and other permanent documents, independent witnesses, and terms of art. Helping the parties to translate their underlying bargain into something that can actually be applied to guide (if not to bind) their subsequent behavior is the main professional task a transactional lawyer faces.

Most scholarly discussion of interpretive problems, especially those dealing with the tension between form and substance, however, has been addressed to courts and other public lawmakers, and not to private ones. The participants in this discussion have argued for formal and for substantive approaches to interpretation, and have based their recommendations on grounds of efficiency, fairness, and party autonomy.

I have argued that the traditional scholarly approach to form and substance founders on a lack of information about the likely consequences of formal and substantive modes of interpretation. From an efficiency viewpoint, the information available at the general level at which courts and legislatures must operate is inadequate to determine the relative magnitude of the relevant transaction costs. From an autonomy viewpoint, the traditional settle of the court system neglects the possibility that different parties in different contexts might prefer — or ought to be delegated the power to choose — one interpretive approach over other. One does see distinctions drawn in the case law and in the commentary between different sorts of contracts; it is generally acknowledged that formalism is relatively more important to experienced commercial actors, and substantive interpretation better suited to transactions involving consumers and other amateurs. But as far as I know there has been no systematic attempt to determine, using the standard tools and methods of the economics of contracts, in which contexts and for which parties formalism is most useful and in which contexts and for which parties a substantive approach is most useful. This essay aims to lay out a basic framework within which such a systematic analysis could take place.