

## EFFICIENT CONTEXTUALISM

Peter M. Gerhart and Juliet P. Kostritsky

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Peter M. Gerhart\* and Juliet P. Kostritsky\*\*

## ABSTRACT

*This article recommends an economic methodology of contract interpretation that enables the court to maximize the benefits of exchange for the parties and thereby enhance the institution of contracting. We recommend a methodology that asks the parties to identify the determinants of a surplus-maximizing interpretation so that the court can determine whether the determinants raise issues that needs to be tried. We thus avoid the false choice between textualist and contextualist methodologies, while allowing the parties and the court to avoid costly litigation. For textualist courts, our methodology helps the judge determine when the terms the parties used are ambiguous enough to require the court to consider context. For contextualist courts, it streamlines the interpretive inquiry by identifying which contextual facts are important and why, which allows courts to avoid or streamline trials. Our method therefore allows courts to avoid the problems of textualism (which can make easy cases difficult) and anything-goes contextualism (which can make difficult cases unmanageable).*

*Our methodology reflects a model of bargaining that emphasizes the divergent interests and preferences of the parties. Although both parties seek to minimize the costs of contracting, the parties have divergent views about those costs and about the tradeoffs each must make to minimize those costs. Accordingly, we deny that courts can find the meaning of a disputed term in the intent of the parties. Instead, we believe that courts must identify (a) the set of obligations that, in the context of the parties' private projects and undisputed terms, increase contractual surplus and (b) the party who is in the best position to avoid the*

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*dispute (and thus lower the cost of contracting) by identifying the terms on which the parties disagree ex ante.*

*We present a structured analytical framework that courts and other enforcers should use to determine which interpretation offered by the parties maximizes the surplus, given the undisputed terms of the contract and the bargaining position of the parties. Courts and other enforcers should not try to influence how other contractors act, except by faithfully determining the surplus-maximizing interpretation; nor should they seek to determine what obligations other contracting parties might have undertaken, nor on how hypothetical bargainers might have bargained.*

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## I. THE INTERPRETATIVE CHALLENGE

Courts play a crucial, but controversial, role in contract interpretation. It is essential that courts enforce contracts, and this requires courts to interpret contracts to determine the parties' obligations.<sup>1</sup> Only an interpretation that reflects the exchange the parties made will support the institution of contracting and enhance socially-valuable transacting and surplus-maximizing.<sup>2</sup> Yet, courts face bounded knowledge<sup>3</sup> and conflicting information about the tradeoffs the parties made, and the cost of acquiring and processing relevant information is itself a cost of contracting, a cost that is magnified if contracting parties lack confidence in a court's ability to interpret the conflict to reflect their exchange. Courts are thus in the position of attempting simultaneously to minimize information and error costs, which co-vary.<sup>4</sup>

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<sup>1</sup> George M. Cohen, *Interpretation and Implied Terms in Contract Law*, in CONTRACT LAW AND ECONOMICS 125, 126–27 (ENCYCLOPEDIA OF LAW AND ECONOMICS, Gerrit De Geest ed., 2d ed. 2011). “Economic analyses generally conclude that if a contract is complete, there is no efficiency-enhancing role for a court other than to enforce the contract according to its terms; that is, incompleteness is a necessary, though not sufficient, condition for an active court role in interpretation and implied terms. . . .” *Id.* “It seems fair to say, however, that many if not most contracts are incomplete, or at least the question of their completeness is itself a legitimate question for judicial interpretation.” *Id.* at 128.

<sup>2</sup> Schwartz and Scott note that the “goal of contract interpretation is to have the enforcing court find the ‘correct answer.’” Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 569 (2003). One of the justifications for finding the correct answer is “consistent with an efficiency-based view of contract law” in which “parties contract to maximize the surplus that their deal can create.” *Id.* That “goal is unattainable if courts fail to enforce the parties’ solution but rather impose some other solution.” *Id.*

<sup>3</sup> See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 44–45 (1985) (“[Bounded rationality] acknowledges limits on cognitive competence” and it is “the cognitive assumption on which transaction cost economics relies.”). This assumption assumes that economic actors are “intendedly rational, but only limitedly so.” *Id.* at 45 (quoting HERBERT A. SIMON, *ADMINISTRATIVE BEHAVIOR* xxiv (2d ed. 1961)). Or, rather, it assumes that while economic actors intend to act rationally, the reality of the study of institutions is that “cognitive competence is limited.” *Id.* at 45; see also Vincent P. Crawford, *Boundedly Rational Versus Optimization-Based Models of Strategic Thinking and Learning in Games*, 51 J. ECON. LIT. 512 (2013); Ronald M. Harstad & Reinhard Selten, *Bounded-Rationality Models: Tasks to Become Intellectually Competitive*, 51 J. ECON. LIT. 496 (2013); Matthew Rabin, *Incorporating Limited Rationality into Economics*, 51 J. ECON. LIT. 528 (2013).

<sup>4</sup> Minimizing error costs requires information. See Schwartz & Scott, *supra* note 2, at 584. Schwartz and Scott understand that “contracts will inevitably be incomplete . . . [w]hen the sum of possible states and partner types is infinite and contracting is costly.” *Id.* at 594–95. Because it is not possible to write a contract with perfect accuracy, “firms will attempt to write contracts with sufficient clarity to permit courts to find correct answers, though with error.” *Id.* at 577; see also Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1583 (2005) (recommending the following formula to frame the tradeoffs that parties make:

Courts have addressed this dilemma by choosing between two approaches: textualist (formalist) approaches<sup>5</sup>—those that save on information costs by assuming that the words the parties used in a contract have an ordinary meaning that reflects the exchange the parties made—and contextualist approaches—those that allow the court to accept a broader range of information but face attendant information costs.<sup>6</sup> The contest between textualist and contextualist approaches has consumed the attention of legal and economic commentators.<sup>7</sup> In this article, we challenge the implicit assumption in the interpretation literature that courts must choose a rule of interpretation before they do the interpretation. We believe the competing rules of interpretation provide a false dichotomy and that neither method serves as a good proxy for determining each party's obligations under the

$$C = x + p(x)[y + z + e(x, y, z)]$$

where  $C$  equals the social costs of a transaction (“social” in the sense of including costs to third parties, such as the courts and future transacting parties, as distinct from just the costs to the parties to the particular contract);  $x$ , negotiation and drafting costs;  $p$ , probability of litigation;  $y$ , parties’ litigation costs;  $z$ , judiciary’s litigation costs; and  $e$ , judicial error costs). When parties invest more in  $x$ , then  $p$  decreases. *Id.* at 1584. Similarly, the probability of judicial error decreases as  $x$ ,  $y$ , and  $z$  increase. *Id.* at 1609.

<sup>5</sup> Schwartz & Scott, *supra* note 2, at 549, 572. Formalists believe that firms prefer courts to use textualist approaches to contract interpretation. *Id.* at 569. The textualist approach uses a narrow evidentiary base comprised of the contract, a dictionary, the judge’s experience, and the pleadings. *Id.* at 572. Contextualist interpretations widen this evidentiary base by allowing in evidence of course of performance, course of dealing, testimony, precontractual documents, and industry custom. *Id.*

<sup>6</sup> Juliet P. Kostritsky, *Plain Meaning vs. Broad Interpretation: How the Risk of Opportunism Defeats a Unitary Default Rule for Interpretation*, 96 KY. L.J. 43, 44 (2007–2008) (“[A contextualist approach] accepts extrinsic evidence about what one or both of the parties to the contract intended that the words would mean or objective evidence of the meaning supplied by context or evidence of how ordinary commercial parties in a trade used the term or behaved in the current contract.”). Professor David Snyder argues that allowing evidence of business norms (like custom and conduct) into interpretive decisions would protect the intention of the parties, who may have contracted with those terms in mind. David V. Snyder, *Language and Formalities in Commercial Contracts: A Defense of Custom and Conduct*, 54 SMU L. REV. 617, 617–18 (2001). This is because “[b]oth verbal and nonverbal conduct are necessary components of language; both are essential ingredients in understanding the parties’ manifestations of assent.” *Id.* Stewart Macaulay’s seminal work detailing the non-use of contract law by businessmen forced commentators to pay attention to the actual context and practices “to understand the functions of contract the whole system of conducting exchanges must be explored more fully.” Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963).

<sup>7</sup> See Avery W. Katz, *The Economics of Form and Substance in Contract Interpretation*, 104 COLUM. L. REV. 496 (2004) (making recommendations to private decisionmakers by applying the scholarship about textualist and contextualist approaches); Schwartz & Scott, *supra* note 2, at 577 (arguing that courts should defer to default formalist methods to interpret the meaning of unclear contractual language).

exchange.<sup>8</sup> In our view, textualist approaches sometimes make easy cases difficult by giving one party a textualist argument that makes little sense but that is expensive to defeat.<sup>9</sup> Contextualist approaches often fail to identify which facts are relevant to the interpretation and therefore fail to focus the factual inquiry.

In place of an interpretive rule, we offer a methodology that shows how courts can best evaluate the dynamics of bargaining relationships to determine the facts that are most relevant to the interpretation. Under the methodology we propose, a court would ask each party to articulate the facts that, if proven, would support a judicial conclusion that the interpretation the party is advancing is, in fact, the surplus-maximizing interpretation for the bargain the parties reached. The determinants of a surplus-maximizing interpretation are those facts that, given the parties' goals and the terms of the agreement that are not in dispute, would necessarily and sufficiently lead to the conclusion that the interpretation was surplus-maximizing. A party seeking to maintain a particular interpretation should be able to show why that interpretation is surplus-maximizing, given the terms of the contract that are not in dispute, because that interpretation would not have been a part of the bargain if it were not surplus-maximizing. This analytical exercise will display for the court two competing hypotheses about the state of the world and the facts that are relevant to establishing one hypothesis as superior to the other.

The court must then determine which hypothesis to accept as an accurate reflection of the bargain the parties made, which it can do by assessing the probability that the determinants of the interpretation offered by each party accurately represent the state of the world. The court would do this by evaluating the discriminatory power of the various offers of evidence that each party makes in support of the relevant determinants of their interpretation. The court must first ascertain which party has the burden of coming forward with evidence concerning each determinant and must ask that party what evidence it has to support their burden. Using a probabilistic assessment, the court can then determine whether the

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<sup>8</sup> This point is implicit in the large literature on the choice of textualist and non-textualist approaches. See Katz, *supra* note 7; see also Stewart Macaulay, *The Real and Paper Deal: Empirical Pictures of Relationships, Complexity and the Urge for Transparent Simple Rules*, in REVISITING THE CONTRACTS SCHOLARSHIP OF STEWART MACAULAY 36–37 (Jean Braucher et al. eds., 2013) (“We cannot have our cake and eat it too. There are costs and benefits flowing from focusing on the paper deal and focusing on the real deal.”). As we make clear in this article, either the paper deal or the real deal can lead to false positives. Examining the paper deal appears to be cheaper than examining the real deal, but the methodology we recommend in this article can, we believe, reduce the cost of examining the real deal.

<sup>9</sup> See discussion *infra* at notes 93–95.

discriminatory power that the evidence carries is sufficient to offset the cost of taking that evidence, given the burden of coming forward with the evidence and the burden of persuasion that each party carries on the particular issues.<sup>10</sup> If the discriminatory power is low enough, the court can, given a dispositive motion by the other party, decide the factual issue without a trial. If the discriminatory power of offered evidence is high enough, that discriminatory power will guide the evidentiary decisions during a trial.

We see five advantages in our approach. First, our approach would allow judges to identify the facts that are necessary to support each party's interpretation so that courts can avoid trials when the necessary facts are improbable and can focus trials on central factual issues when the necessary facts are contestable. Relatedly, our method does not require a court to choose between a thin and a thick evidentiary base.<sup>11</sup> Instead, the appropriate evidentiary base is revealed as part of the analysis of which interpretation is likely to be surplus-maximizing.

Second, our approach would avoid the social cost that is now imposed by textualist devices like the plain meaning and parol evidence rules, which allow parties to assert interpretations that, upon straightforward analysis, could not be surplus-maximizing. As a result, courts will be able to get rid of unmeritorious

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<sup>10</sup> Our conception of discriminatory weight and burdens of proof and persuasion is informed by DALE A. NANCE, *BURDENS OF PROOF: DISCRIMINATORY POWER, WEIGHT OF THE EVIDENCE, AND THE TENACITY OF BELIEF* (Cambridge Univ. Press 2015). Our approach builds on the work of Yair Listokin. See Yair Listokin, *Bayesian Contractual Interpretation*, 39 J. LEGAL STUD. 359 (2010). Like Listokin, we create two hypothetical bargains and encourage the court to use Bayesian analysis to determine which hypothetical bargain is more likely to reflect the bargain the parties actually made, taken as a whole. Unlike Listokin, we do not assume that the parties had formed a joint intent with respect to the disputed term. Instead, we assume, more realistically, that the parties had no joint intent with respect to the disputed term or that they had joint intent and one party is acting opportunistically in advocating a different interpretation. In light of that assumption, we believe the best methodology will treat the opposing interpretations as distinct hypotheticals and will analyze each one separately to assess the comparative likelihood of each being surplus maximizing.

Under our methodology, the court treats each claim as a hypothetical bargain and determines the likelihood that the factual determinants of that claim are true, comparing that probability with the probability that the factual determinants of the other interpretation are probabilistically accurate. Often, this will come down to determining whether a particular fact is true because the determinant that makes one interpretation surplus maximizing will make the other interpretation not surplus maximizing. One can see the difference between our approach and Listokin's by examining our different treatment of *Jacob & Youngs v. Kent*, 129 N.E. 889 (N.Y. 1929). See *infra* text accompanying notes 82–83.

<sup>11</sup> Schwartz & Scott, *supra* note 2, at 572.



claims faster, and this reduces the cost of contracting, reduces opportunism,<sup>12</sup> and avoids the invocation of diffuse concepts like equity.<sup>13</sup> Third, by making their economic reasoning clearer, courts will allow precedent to be built on the accumulated understanding of the economics of bargaining relationships,<sup>14</sup> allowing courts to learn from each other and increase predictability, which will further decrease the cost of contracting.

Fourth, the method would at the margin, improve outcomes. Although we believe that even generalist judges<sup>15</sup> exercise an informed intuition about the central interpretive questions they face, and use probabilistic Bayesian thinking and generally get interpretations right, our method allows courts to check their intuition by using a structured way of understanding the economics of the relationship they are examining and to revise their intuition when the methodology yields counterintuitive results.

Finally, we believe that our approach would bring coherence to contract theory. The economic literature on interpretation sometimes suggests that the choice of interpretive method ought to vary depending on the sophistication of the parties<sup>16</sup> and the nature of their private choices.<sup>17</sup> Under these approaches, a court

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<sup>12</sup> See Kostritsky, *supra* note 6 (discussing control of opportunism as a course of gains from trade); see also Oliver E. Williamson, *Opportunism and Its Critics*, 14 *MANAGERIAL & DECISION ECON.* 97, 101 (1993) (finding “failure to make prominent and insistent provision for opportunism in economic theory”).

<sup>13</sup> Kenneth Ayotte et al., *A Safety Valve Model of Equity as Anti-Opportunism* (Nw. Law & Econ. Research Paper No. 13-15, 2013).

<sup>14</sup> It is important for courts to understand the economics of a bargain. See VICTOR GOLDBERG, *FRAMING CONTRACT LAW: AN ECONOMIC PERSPECTIVE* (2006). For a discussion of Goldberg in the context of *Columbia Nitrogen Corp. v. Royster Co.*, 451 F.2d 3 (4th Cir. 1971), see *infra* Part V.B; see also George S. Geis, *Economics as Context for Contract Law*, 75 *U. CHI. L. REV.* 569 (2008).

<sup>15</sup> See Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Contract and Innovation: The Limited Role of Generalist Courts in the Evolution of Novel Contractual Forms*, 88 *N.Y.U. L. REV.* 170 (2013). Generalist courts are “the nonspecialized workhorses of formal dispute resolution.” *Id.* at 174. “Most contemporary courts are generalists.” *Id.* at 192. The authors contrast generalist courts, whose “knowledge of doctrine and the effects of its application in the usual run of cases may be an insufficient or erroneous guide to decisionmaking” in complex transactions, with specialist courts, like the Delaware Court of Chancery. *Id.* at 191. Specialized courts have “expert judges with significant experience in the field[.]” which ensures that “judicial decisions will be taken with the fullest possible awareness of current and evolving understandings of good practice.” *Id.* at 207–08.

<sup>16</sup> See *id.* at 175; see also Jody S. Kraus & Robert E. Scott, *Contract Design and the Structure of Contractual Intent*, 84 *N.Y.U. L. REV.* 1023, 1026 (2009).

first classifies the nature of the bargaining and then, based on that classification, or on the party's explicit choice, determines what interpretive method to use.<sup>18</sup> Under our approach, the analysis uses the bargaining relationship not as a filter that determines the kind of interpretive method the court will follow,<sup>19</sup> but as a basis for identifying the relevant facts that must be resolved to determine if the interpretation is surplus-maximizing. The interpretive method is general, focusing on the particular contextual facts insofar as they are relevant to the application of the general method.

Our methodology shares some foundational assertions with most other economic theories. Like formalist approaches to interpretation, we agree that the law ought to enforce the obligations the parties agreed to in the way the parties agreed.<sup>20</sup> Our methodology is consistent with various strands of relational contract theories<sup>21</sup> in that we recognize that interpretation must be done with an appreciation of the relationship the contractors formed and of how they designed the contract to

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<sup>17</sup> Party choice theory “argues that parties must expressly opt into contextual interpretation or live with the consequences of a narrow, off-the-shelf default rule.” Juliet P. Kostritsky, *Contract Interpretation: Judicial Role Not Parties' Choice*, in COMMERCIAL CONTRACT LAW TRANSATLANTIC PERSPECTIVES 240, 241 (Larry A. DiMatteo et al. eds., 2013). The problem with this theory is that it restricts the courts' power “to control opportunistic behavior at the expense of parties likely to assume that courts have such power as a matter of course.” *Id.*

<sup>18</sup> If no party choice has been made to indicate a contrary choice, the default rule is for majority talk and a textualist approach. See Schwartz & Scott, *supra* note 2, at 577.

<sup>19</sup> An example of a filter would be if the court found that a relationship between commercial parties justified a textualist approach.

<sup>20</sup> Economists going back at least to Hayek are justifiably wary of any methodology that looks to substitute the court's judgment about what the parties should or might have agreed to, for example, using “deliberately designed” rules and “the tenets of Cartesian rationalism” for the court's judgment about what the parties actually agreed to or would have agreed to were they fully informed. See FRIEDRICH A. HAYEK, LAW, LEGISLATION AND LIBERTY (1983). A court methodology attuned to the parties' actual agreement based on full information seems to take account of the fact that it will be hard for courts to design rational rules for all parties since the parties will be operating according to institutions and customs that cannot be apprehended ahead of time and incorporated into a predesigned rule. Moreover, the parties will be able to “adapt [themselves], to millions of facts which in their entirety are not known to anybody.” *Id.* at 13. Courts must pay attention to the facts of each case. In doing so and in using the methodology suggested here, courts may become aware of the “development of practices which have prevailed because they were successful.” *Id.* at 18.

<sup>21</sup> See Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981); Ian R. Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a “Rich Classificatory Apparatus,”* 75 NW. U. L. REV. 1018 (1981); Ian R. Macneil, *Restatement (Second) of Contracts and Presentation*, 60 VA. L. REV. 589 (1974); William C. Whitford, *Ian Macneil's Contribution to Contracts Scholarship*, 1985 WIS. L. REV. 545 (1985).

reach their divergent goals. Hence, our article differs from analysts who see a contest between courts and party autonomy.<sup>22</sup> The court's task is to preserve party autonomy, while at the same time recognizing that the bargaining parties may have exercised their autonomy in disparate ways.

We, however, make three important assertions about interpretation that challenge conventional wisdom. First, we deny that the goal of interpretation is to find the intention of the parties. An interpretive dispute indicates either that the parties lacked a common intention or that one of the parties is disingenuous about its *ex ante* intention. Because courts cannot search for joint intent when an interpretive dispute arises, we think that courts get better results by determining the obligation that maximizes the surplus of the exchange, given the terms that are not in dispute, or by identifying the party that could have increased the surplus by avoiding interpretive disputes.<sup>23</sup> Either way, the interpretive analysis should not assume that the parties had a meeting of the minds or joint intent on the interpretive issue in dispute.

Second, and relatedly, we believe, as we have already indicated, that the purpose of interpretation is to determine the obligations of the parties under the exchange they made. Any other goal, like the search for hypothetical intent, an ideal exchange, or an assumed interpretive preference<sup>24</sup> will disable the parties from maximizing the surplus from the exchange and impose a cost that would reduce gains from trade.

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<sup>22</sup> See Gilson, Sabel & Scott, *supra* note 15, at 174 (stating that “respect for party autonomy . . . is under threat from two directions” because a court can substitute default rules that disregard parties’ intentions and a “court can reinterpret or disregard the parties’ agreement in favor of the judges’ understanding of the context of their dealings.”). *But see* Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 MICH. L. REV. 489 (1989) (arguing that default rules do not conflict with party autonomy).

<sup>23</sup> Our assertion is that the parties can act opportunistically *ex ante* by failing to clear up ambiguities that could easily have been avoided, so that courts are justified in identifying the party that was least unreasonable in allowing the ambiguity to arise *ex ante*—that is, the low cost risk avoided. Because each party prices the contract on the basis of the interpretation it gives the terms, mistakes as to meaning either give one party the potential of an unearned benefit or reduce the surplus that should have been available. Although the *Restatement (Second) of Contracts* Section 201 embraces this factor, it does so without the associated structure for better assessing that factor in context. *See* RESTATEMENT (SECOND) OF CONTRACTS § 201 (1981). Nor does Section 201 offer any structured methodology for courts to better assess comparative probability of one interpretation being value maximizing. *Id.*

<sup>24</sup> Posner, *supra* note 4, at 1590.

Third, and again relatedly, we suggest that interpretation cannot be a rule-based enterprise<sup>25</sup> but must be based on a methodology that identifies the kind of tradeoffs the parties must have made (given the terms they agreed on). A rule-based approach starts the analysis with a presumption that one side or the other must overcome. A textualist rule may say, for example, that if the words the parties used are unambiguous, the words should be given their unambiguous meaning. This, of course, then shifts the court's focus to the question of how to determine what "ambiguity" means.<sup>26</sup> At the other extreme, a rule-based version of contextualism may say that usages of trade may be used to explain but not contradict the contract's terms. This focuses analysis on the distinction between explaining and contradicting the terms.<sup>27</sup> A rule-based approach inevitably reduces itself to the analysis of a word in the rule and therefore focuses on the word rather than the contractual relationship. Under our approach, courts would not start with any presumptive rule. They would simply trigger a structured way of analyzing the relationship the parties formed and determine what interpretation of the disputed terms best maximizes the contractual surplus.

Our distaste for rule-based approaches to interpretation stems from the belief that rules provide poor proxies for finding the surplus-maximizing interpretation and have several troubling side effects. First, rules invite scholars to fight over the rules themselves and to neglect the study of the relationship between the parties and how to recognize unity from their separate positions. Scholars who advance rules seek to influence courts to choose a rule of interpretation (a default rule) around which the parties can negotiate.<sup>28</sup> But negotiations are particular, not general, and the evaluation of any particular negotiation must be based on evidence about how the parties disputing the interpretation bargained, not upon general

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<sup>25</sup> We are not challenging the economic goal advanced by formalist commentators such as Alan Schwartz and Robert Scott. We are challenging their view of legal methodology, and, in particular, their view that courts ought to choose a default interpretive rule around which the parties can negotiate. *See* Alan Schwartz & Robert E. Scott, *Contract Interpretation Redux*, 119 YALE L.J. 926, 931 (2010) [hereinafter Schwartz & Scott, *Contract Interpretation Redux*]. In our view, determining a rule of interpretation is unsatisfactory as legal methodology and as a workable way of understanding the bargaining relationship between contractors. *See infra* text accompanying notes 50–52.

<sup>26</sup> STEVEN J. BURTON, *ELEMENTS OF CONTRACT INTERPRETATION* 105–49 (2009).

<sup>27</sup> E. ALLAN FARNSWORTH, *CONTRACTS* § 7.13, 475 n.36 (4th ed. 2004) (citing “the well established rule . . . that evidence of custom or usage in the trade is not admissible where inconsistent with the express terms of the contract”).

<sup>28</sup> *See* Schwartz & Scott, *supra* note 2, at 547; *see also* Kraus & Scott, *supra* note 16, at 1027.

beliefs about how the parties might have bargained.<sup>29</sup> In our view, determining a default rule of interpretation is unsatisfactory as legal methodology and as a workable way of understanding the bargaining relationship between contractors.

Second, rule-based approaches threaten to splinter our understanding of contracts, providing one rule for sophisticated business parties, another for business contracts where the parties want to get to the performance, and still another for consumer contracts. The splintering of contract theory is proceeding apace.<sup>30</sup> By contrast, we propose a methodology that is context neutral but in which the context of the particular bargaining relationship is accounted for as the methodology is applied.

Our major points of departure from current interpretive ideas—the lack of intent with respect to disputed terms, the inability of rules to lead to effective interpretations, and our dislike of reasoning from general beliefs about how most people bargain—reflect a view of bargaining relationships that emphasizes the disparity of interests of the parties, rather than the parties’ common interests. In our view, courts must interpret contracts by understanding the tradeoffs that the parties must have made given the terms of the bargain that are not in dispute and the disparate goals of the parties. Accordingly, courts and other interpreters must reason from a bargaining model that emphasizes the divergent interests of the parties and the way those divergent interests give rise to a range of tradeoffs that the parties must make.

We present the bargaining model that undergirds our analysis in Section II. Here, we identify the central problem of interpretation—namely, that contracting parties face multiple efficient equilibria, which makes it difficult to determine which equilibrium point the parties actually chose *ex ante*. As a result, courts need an interpretive methodology that allows them to identify which among several

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<sup>29</sup> *But see* Kraus & Scott, *supra* note 16, at 1027 (suggesting that when the parties use a specific term, “it seems likely that the parties here specified an objective price index precisely to avoid the costs of a judicial inquiry into accuracy”). Given the disparity of their information base, that presumption may not hold. As the next section of the article makes clear, there are plenty of barriers to adopting a joint understanding of the meaning of a term. More importantly, particular controversies ought to be decided on the basis of the bargaining relationship that gave rise to the controversy, not on general assumptions about how bargaining parties generally act. Although it is possible that the parties intended to rule out resort to the courts, whether this is true would depend on the bargaining context, and it is really impossible to know what the average person in a similar situation would have done, and in any event, they may have had disparate views about what would happen if the term failed.

<sup>30</sup> *See* Gilson, Sabel & Scott, *supra* note 15, at 175; Kraus & Scott, *supra* note 16, at 1026.

equilibria the parties actually agreed to given their divergent positions and the terms that are not in dispute. Because neither party can know the private projects of the counterparty, each party's projection of its future stream of returns depends on its assessment of how the counterparty assessed the risks or understood specific or implicit terms of the contract. The parties make tradeoffs in uncertainty that reflect their divergent, not their common, interest and a court must employ an interpretive methodology that allows the court to determine what tradeoffs the parties made, or what tradeoffs they would have made if the party with superior information about the potential for discrepant understanding had identified the discrepancy and avoided it.

Our analysis of the bargaining process also demonstrates why an interpretive methodology based on an interpretive proxy—such as textualism, usages of trade, or an assumption about the joint intent of the parties—is likely to weaken the institution of contracting. In Section III we show that the purported advantages of textualism are undercut by the social costs of textualism, in particular the high social cost of avoiding textualist outcomes that are implausible. We also argue that the dichotomy between textualism and contextualism disappears once courts use a methodology that, like ours, allows them to determine what meaning ought to be given to the terms of the contract and how to reduce the costs of taking contextual details into account.

Section IV then presents a structured way by which courts can identify the facts that are necessary determinants of a surplus-maximizing interpretation. We show that the competing interpretations the parties offer can be understood as rival surplus-maximizing claims, and that those claims will be founded on different empirical assertions. By examining the competing factual assertions, the court will be able to identify the interpretation that, on a probabilistic basis, is the interpretation that reflects the exchange the parties made or identifies which of the parties should have identified a misunderstanding so that the parties could price the deal without the misunderstanding. We also explain how a court will be able to avoid trials or shorten trials through dispositive motions and by narrowing the empirical issues that are relevant to an interpretation.

Section V further illustrates the methodology we advance using various cases that show how our methodology avoids making easy cases difficult (the problem of textualism) while making difficult cases easy (thus taming contextualism), and how our methodology allows commentators to more accurately assess whether courts are up to the task of interpretation. The concluding section VI summarizes the contributions that our article seeks to make to the institution of contracting. Here we emphasize the importance of concentrating on the facts of the particular controversy before the court, the importance of understanding the private goals of the contracting parties and how those goals are likely to influence the terms of exchange, and the benefit of focusing on the surplus-maximizing determinants of

an interpretative claim as a way of reducing complexity and fostering dispositive motions.

## II. BARGAINING DYNAMICS

Courts need to interpret contracts using a model of the bargaining process that appreciates the parties' divergent positions and how the parties have addressed the divergences. The divergent positions create the risks that contracting is designed to address. Courts must also be aware that bargaining parties choose between varieties of bargains that could be made; they bargain in the face of multiple equilibria and settle on one equilibrium point that represents the tradeoffs they have made.<sup>31</sup> A bargaining model that emphasizes the parties' divergent interest and choice among multiple equilibria is important because the task of interpretation, ultimately, is to determine what tradeoffs the parties made or could have made if the party with an ability to avoid the interpretive problem had sought to do so. In this section, we describe the model that ought to inform a court's understanding of bargaining relationships.

Naturally, the court starts with an assessment of the contract terms that are not in dispute and with awareness that the parties negotiate over a range of possible terms that would be acceptable to each party because they would leave each party better off than her current situation. This point is implied by the Edgeworth Box, which illustrates the range of tradeoffs that potential contractors will make in

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<sup>31</sup> As to multiple equilibria in contract, see George S. Geis, *Economics as Context for Contract Law*, 75 CHI. L. REV. 569, 594 (2008) (reviewing VICTOR GOLDBERG, *FRAMING CONTRACT LAW: AN ECONOMIC PERSPECTIVE* (Harvard Univ. Press 2006)). He cites standard works on game theory such as AVANISH DIXIT & SUSAN SKEATH, *GAMES OF STRATEGY* (W.W. Norton, 2d ed. 2004), and ROBERT G. BAIRD, ROBERT H. GERTNER & RANDAL C. PICKER, *GAME THEORY AND THE LAW* 35 (Harvard Univ. Press 1994) (pointing out that there may be more than one efficient contract design). We use the concept of multiple equilibria to point out that negotiating parties are bargaining over a range of tradeoffs, each of which is Pareto efficient, and to argue that interpretation must be designed to determine which combination of tradeoffs the parties actually chose. This idea came from an e-mail communication from Professor Emeritus Ron Coffey. See E-mail from Ronald Coffey, Professor Emeritus, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Everett D. & Eugenia S. McCurdy Professor of Contract Law, Case Western Reserve University School of Law (Sept. 8, 2010, 19:59 EST) [hereinafter E-mail from Ronald Coffey] (on file with authors); see also KEN BINMORE, *NATURAL JUSTICE* 14 (2005) (noting the importance of fairness norms to select among multiple equilibria and stating that "fairness is evolution's solution to the equilibrium selection problem for our ancestral game of life"). The idea of multiple equilibria is applied in the context of property law in PETER M. GERHART, *PROPERTY LAW AND SOCIAL MORALITY* (2014).

considering various ways of arranging the burdens and benefits of the contract.<sup>32</sup> Once the deal is agreed to, the alternative terms drop away and the “terms finally accepted form the appropriate resolution of the confrontation as to terms.”<sup>33</sup> Accordingly, a court that is asked to interpret a contract is asked to identify, from the set of tradeoffs the parties could have chosen, the tradeoffs that the parties actually chose. The court cannot fail to make an interpretation, for that would denigrate the idea of enforcement. And courts are not to upset any bargain or substitute new terms because they lack the parties’ knowledge about whether the term would have been acceptable.<sup>34</sup>

Under these circumstances, it will not be immediately clear whether the plaintiff’s or the defendant’s interpretation will maximize surplus; which interpretation maximizes surplus will depend on what one believes about the precise tradeoffs the parties made over the range of exchanges they might have made. The court must therefore identify and evaluate the factors the parties must have taken into account in forming the bargain and what the tradeoffs tell us about the risks each part assumed and the meaning each attributed to the contractual language. Although the court will not have direct access to the parties’ negotiating strategy, by identifying the underlying empirical claims that must be true for the deal to be surplus-maximizing, the court can determine what decisions the parties must have made, including their decisions about the kind and amount of risk that each would assume.

#### A. *A Model of the Bargaining Relationship*

Contract law must address a wide variety of relationships, each with unique negotiating characteristics, and courts need to embed their interpretation in an understanding of the dynamics of the particular bargaining relationships they are evaluating. In this section, we present a model of the negotiating process that

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<sup>32</sup> PATRICK BOLTON & MATHIAS DEWATRIPONT, *CONTRACT THEORY* 6 (2005) (depicting contract curve of Edgeworth Box).

<sup>33</sup> E-mail from Ronald Coffey, *supra* note 31.

<sup>34</sup> A court ought not, for example, force a buyer and a seller to transact over additional objects in the possession of each party on the theory that doing so would create surplus or that the object would be more valuable in the hands of party B than the hands of party A who currently holds the object. E-mail from Lee Fennell, Max Pam Professor of Law, The University of Chicago Law School, to Juliet P. Kostritsky, Everett D. & Eugenia S. McCurdy Professor of Contract Law, Case Western Reserve University School of Law (Aug. 9, 2009, 17:35 EST) (on file with authors) (“For example, I’m pretty sure you would not favor a court spontaneously deciding to force the seller and buyer to transact over additional objects in the possession of each that were not mentioned in the contract at all simply because they would be more valuable in the hands of the other party.”).



touches base with a standard set of considerations that are likely to shape the cost of transacting and the kinds of costs each party is willing to accept.<sup>35</sup> This section, while building on existing models, adds to the literature in two ways. First, we emphasize that parties are not jointly determining how much to invest in negotiating, reducing interpretive risk, and pricing the risk of nonperformance. Second, we emphasize even more than the existing literature on transactions costs, the significant barriers to bargaining, including barriers to bargaining over interpretive risk. The implications of this model, as we will enumerate, are that contracts are likely to be incomplete and that each negotiation has its own way of settling on which among several equilibrium points the parties will choose.<sup>36</sup>

Each party enters negotiations with individual, return-generating private projects as her goal. The counterparty's promises are an input into the value of each party's projects, and each party has a view of the probabilistic contribution of the other party to the value of her projects. Neither party has good knowledge about the private projects of the counterparty, and neither party is guaranteed to share her private projects with much accuracy. Indeed, each party is interested in the counterparty's private projects only insofar as the counterparty's projects are an effective input into her private projects. Each party's evaluation of the exchange depends on its evaluation of whether the counterparty is likely to perform the exchange in accordance with the obligations that that party understands to be part of the exchange. That is the sense in which the promises of each party are interdependent.

Each party also understands the uncertain future attributes of the other party's performance in accordance with her expectations, which vary with the vicissitudes of nature and many unknown (and often unknowable) characteristics of the counterparty. Each party therefore bears the cost of this uncertainty, which decreases the present value of the exchange. Each party compares exchange terms with potential exchange terms that might reduce the cost of uncertainty by more than the cost of employing those terms (because terms are costly to negotiate),

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<sup>35</sup> Undoubtedly, a more complete set of negotiating considerations would aid courts in enforcement tasks other than interpretation, such as determining which excuses for nonperformance to honor and the appropriate remedies for breach. We do not attempt a complete set of bargaining considerations in this work.

<sup>36</sup> The model we present is drawn largely from an e-mail communication from Professor Emeritus Ronald J. Coffey. See E-mail from Ronald Coffey, *supra* note 31.

including the option of having no exchange terms.<sup>37</sup> The meaning each party assigns to a term will reflect the uncertainty costs they compute, which is why each party may use the same term but assign different meanings to it. Each party also has private information about how it is interpreting the terms that are used in the contract and a basis for thinking about whether the counterparty attributes the same meaning to the terms.

Crucial to this model is that the parties have individualistic attitudes toward risk,<sup>38</sup> and individualistic levels of uncertainty about their counterparty's ability or willingness to perform in accordance with the surplus-maximizing exchange they ultimately make.<sup>39</sup> To be sure, the parties' common goal is to create an exchange out of their individualistic private interests, but their commitment to their common goal is a commitment to their private projects; the parties do not seek an agreement as an end in itself, but only as a means to each party's private and individualistic ends. The parties bargain successfully only when the bargain achieves each party's private projects in the light of each party's attitude toward risk and uncertainty about their counterparty's ability and willingness to perform.

Although each party has distinct private goals, each party understands that in order to deploy the institution of contracting to achieve her private goals, she must accommodate the interests of her counterparty, including her counterparty's interest in reducing the uncertainty-costs of contracting. Each party will therefore work to design a contract that minimizes costs for herself and her counterparty to the extent that cost reduction does not unduly limit her ability to achieve her own projects. The parties may have very different views of the way the contract will work to minimize costs.<sup>40</sup> Although each party has an interest in reducing the costs of performance of the other party (in order to increase contractual surplus), each party also wants the other party to absorb costs that are necessary to meet that party's private projects. A buyer of high quality steel wants to reduce the cost of supplying the steel while simultaneously inducing the investment that is necessary to make

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<sup>37</sup> Naturally, each party also compares the range of exchange terms with the cost of other means of achieving its private projects.

<sup>38</sup> See generally FRANK KNIGHT, *RISK, UNCERTAINTY AND PROFIT* (1921).

<sup>39</sup> For a discussion of behavioral uncertainty, see WILLIAMSON, *supra* note 3, at 56–60; see also JACK HIRSHLEIFER & JOHN G. RILEY, *THE ANALYTICS OF UNCERTAINTY AND INFORMATION* (Mark Perlman ed., 1992).

<sup>40</sup> E-mail from Ronald J. Coffey, Professor Emeritus, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Everett D. & Eugenia S. McCurdy Professor of Contract Law, Case Western Reserve University School of Law (June 1, 2013, 12:12 EST) (on file with authors).

the steel high quality. A seller of high quality steel wants to lower the cost of receiving payment for the steel while simultaneously addressing the risk that it might not be paid (which will increase the cost of contracting). Although each party will try to minimize its costs of contracting (for doing so increases contractual surplus) the parties face different costs that they seek to minimize. The costs of contracting for each party include: (a) each party's cost of performance, (b) negotiating costs, (c) the costs of interpretive risk, (d) the cost incurred if full performance by the other party does not yield the expected benefits, and (e) the cost of nonperformance by the other party (performance risk). The costs are interrelated in important ways.

### 1. Negotiating Costs

Generally, neither party has the goal of negotiating the perfect contract. The contract is the means to the parties' end, not the end itself. The more time a party spends negotiating, the more it delays the performance that will make it better off. Parties want their counterparty's performance, not a well-negotiated deal. That is why much contracting is quite informal.<sup>41</sup> For example, a buyer calls a seller to ask about the availability of a part the buyer needs in his business operation. The buyer wants the part, not the perfect contract and will accept some interpretive or performance risk in order to get what it needs as quickly as possible. That is one of the main reasons why parties underspecify their obligations and rely on post contracting adjustments and informal enforcement to reduce the costs of contracting.

Sometimes the cost of interpretive risk, uncertainty, or performance risk makes the time spent in negotiating and designing the relationship well worth it—cases where the value of deals and amount of uncertainty are large<sup>42</sup> and where time is not as important. Under those circumstances, a court may be able to observe signs that the parties intended the final contract to embody a full specification of their obligations and determine what the gaps in the specification of obligations means for the obligations of the parties. The face of the contract may itself reveal whether care was taken in drafting the agreement, and the terms of the contract

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<sup>41</sup> Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 57 (1963) (“Important transactions not in the ordinary course of business are handled by detailed contract. . . . More routine transactions commonly are handled by what can be called standardized planning.”).

<sup>42</sup> *Id.*; see also Schwartz & Scott, *Contract Interpretation Redux*, *supra* note 25, at 963 (arguing that sophisticated parties “know better than courts how best to trade off these front-end and back-end costs”).

may reveal the level of completeness of the agreement. The parties can employ merger clauses and other signals that guide a court in determining the level of care that went into the negotiations and the articulation of the obligations of the parties. In those circumstances, the contract looks to be the end and not the means. However, even when courts confine their interpretation to the four corners of the contract, it is not because the contract is the end; it is because the written contract provides enough evidence of the tradeoffs the parties made so that their private ends (and the relationship between the private ends) are transparent.

However, the amount each party is willing to invest in negotiating costs will differ depending on individual preferences, goals, foresight, and trust in the mechanisms of informal enforcement. One party may agree to terms thinking that the terms are precise enough to deal with all contingencies while the other party may realize that a term, while precise, does not cover all contingencies; that party may plan to rely on informal enforcement to address post-contracting disputes. In such cases, a court will not be able to determine the level of completeness nor how much investment was made in drafting. The tradeoffs the parties make are not transparent to each other and will not be transparent to a court.

## 2. Interpretive Costs

Each party also faces interpretive costs: the costs incurred if one party misunderstands the obligations of the exchange as the counterparty sees them, and the costs of resolving that misunderstanding, including post-contractual negotiations and judicial enforcement (which is costly and risks erroneous interpretations).<sup>43</sup> Each party will, in effect, determine whether she ought to decrease the interpretive cost by raising the possibility of a misunderstanding with the counterparty and negotiating further, taking into account other ways of addressing the interpretive costs, including post-contractual discussions and court enforcement. The negotiating costs and the interpretive costs are inversely related. Other things being equal, the more negotiating cost each party expends, the less an interpretive cost the party faces.

Moreover, as already mentioned, each party has private information about the meaning that it ascribes to the contract's terms. It also has a basis for reasoning about the meaning that the counterparty ascribes to the same terms. It can reason from what it knows about the private goals of the counterparty, the counterparty's

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<sup>43</sup> Juliet P. Kostritsky, *Interpretive Risk and Contract Interpretation: A Suggested Approach for Maximizing Value*, 2 ELON L. REV. 109, 118 (2011) (referring to the fact that some residual interpretive costs will never be eliminated by contract drafting due to uncertainties).

experience in the field, and general experience about how people in the counterparties position are likely to use a certain term. Each party therefore has an ability to raise questions about the possible discrepant uses of the term and to clarify any misalignment of meaning.

Residual risk from underspecified terms in the contract is inevitable and conserves on upfront negotiation costs. Obligations are underspecified for many reasons: the inability of one party to foresee or disclose future states of the world,<sup>44</sup> assumptions that turn out to be incorrect, tunnel vision, and inadvertence.<sup>45</sup> Beyond these cognitive problems is the cost structure of negotiating over interpretive risks. Some interpretive issues cannot be anticipated at any cost. But other interpretive issues can be addressed more cheaply after the contract is signed, either by post-contract negotiations or by court enforcement.

When terms are underspecified, the parties face the risk of costly or erroneous judicial interpretations. Judicial error occurs when a judicial decision settles on an interpretation that does not reflect obligations that would make the deal surplus-maximizing, given the undisputed terms the parties agreed to *ex ante*. Such an interpretation would be costly for two reasons. First, such an interpretation would upset the bargain the parties made, resulting in undeserved gains for one of the parties and undeserved losses for the other; such an interpretation would adversely affect the institution of contracting by raising the uncertainty of bargains. Second, any interpretation that is not surplus-maximizing would increase the costs of contracting by making it more difficult for a party to rely on post-contracting negotiation and enforcement to address interpretive risk, resulting in overinvestment in negotiated reductions in interpretive risk. The parties to a contract depend on courts to choose the surplus-maximizing interpretation because only that interpretation allows the parties to reduce the sum of negotiating and enforcement costs.

### 3. Cost of Nonperformance

Negotiations function to reduce the cost each party faces in the counterparty's nonperformance. Contract design can address that risk because contract design can build in ways of measuring or protecting against the counterparty's

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<sup>44</sup> See WILLIAMSON, *supra* note 3, for a discussion of bounded rationality.

<sup>45</sup> On its face, it might look as if negotiation is always preferable to enforcement, given the high cost of enforcement. But interpretive problems may never arise or may be informally addressed in the shadow of court enforcement. Negotiating parties are likely to discount the cost of enforcement.

nonperformance. Although contract design can be expensive, especially when new technologies result in relationships where the risks are not easily addressed under existing contracting models, for many other kinds of relationships the ways of designing contracts to avoid performance uncertainty are well known and are often accepted without nuanced negotiation.

But even when parties agree on the need to control the risk of the other party's non-performance, the parties may have different views on how the agreed-upon language will accomplish their individual goals and what to do in the event that there is a dispute. For example, when payment is to be made on the delivery date, what happens when the delivery is late? On what day should the rate be calculated, the scheduled or actual delivery date?

#### 4. Finding an Equilibrium Point

Each party makes its own tradeoffs about interpretive risk, performance risk, and negotiating costs. Each party makes that calculation with imperfect information about the differing tradeoffs being made by the counterparty. The parties reach an agreement at an equilibrium point where each party anticipates the maximum of benefits over costs under terms that yield the counterparty the maximum of benefits over costs, given the two parties' reservation prices—the point at which one party or the other will not make the deal.<sup>46</sup> At that point, the parties have maximized the surplus from exchange and decided how the surplus would be divided between the parties. The contract serves as an institution whose terms the parties have set so that each party can pursue her private projects while each party's behavior is constrained by the institutional obligations to meet the counterparty's expectations.

Importantly, it is impossible to foresee how the parties will minimize the costs along the various vectors available to them. Each bargaining party separately determines each of these costs and whether it is worth negotiating over them, but the costs are unknown to the counterparty. As Judge Posner has said: “the equilibrium state is unclear because of the mutual dependence of the variables and the difficulty of predicting expected litigation costs.”<sup>47</sup> That is why we think that the tradeoffs the parties made must be understood on a case-by-case basis rather than with predetermined assumptions.

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<sup>46</sup> Given the number of ways of determining this equilibrium point, the relationship of benefits to costs for each of the parties depends on their other ways of achieving their private projects and their ability to convince their counterparty of those alternatives. It is impossible and unnecessary to determine which point the parties choose.

<sup>47</sup> Posner, *supra* note 4, at 1613.

Several features of this bargaining model are noteworthy. Each party has the ability to reduce its interpretive risk by making the contract more specific with respect to the risks it cares about or to offer design elements that reduce its risk. Each party had information about its own interpretation of the terms that are being used and about the interpretation the counterparty is likely to make. Each party makes a decision about the cost and value of further specification, given the other ways by which it might address the risks it faces and its other contracting options. Each party separately determines whether to disclose information about interpretive risk and about whether it is better to reduce interpretive risk by further negotiations or by relying on enforcement and negotiating in the shadow of enforcement.<sup>48</sup>

Given this model of bargaining, one (or both) of the parties has the ability to reduce enforcement costs by investing in negotiation and thus minimizing interpretive uncertainty. Through the language they use and the design they adopt, the parties can control the interpretive risk and minimize enforcement costs. But it makes sense for each party to also reduce interpretive uncertainty by relying on enforcement, provided that the enforcement is set up to determine a surplus-maximizing interpretation to identify the relevant obligations. Any other interpretive method will increase each party's investment in negotiations and reduce the surplus generated by the contract.

### *B. Implications*

We draw several important implications for interpretation from this bargaining model. First, interpretation must take place with an awareness of the private projects that each party was seeking in a negotiation. Those private projects reveal the bargaining position each party must have taken, the assumptions they probably made about what they would give up and what they would get, and the likely tradeoffs they would accept as meeting the goals and expectations for their private projects.

Second, the divergent views of the parties about interpretive and performance risk make it unlikely that the parties would have formed a joint view about the "need to anticipate and control what portions of their agreements will be legally enforceable."<sup>49</sup> Nor would they necessarily agree on an interpretive methodology

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<sup>48</sup> See Robert Cooter, Stephen Marks & Robert Mnookin, *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEGAL STUD. 225 (1982).

<sup>49</sup> Kraus & Scott, *supra* note 16, at 1031.

they would want a court to adopt.<sup>50</sup> And even if the parties agreed on seemingly precise terms, the parties might not agree on the meaning of the terms, and thus might not agree on whether “[r]ules withdraw authority from courts to determine particular performance obligations and instead direct them to enforce the formal obligations that the parties have explicitly specified in advance.”<sup>51</sup> Because parties make different tradeoffs of risk, courts will be precluded from finding a joint intent on any terms that are in dispute; they must make judgments about obligations of the parties from terms that are not in dispute and the bargaining goals of each of the parties.

Third, although barriers to bargaining are well-documented in the literature, we believe that because of the divergent positions of the parties, the barriers to bargaining are far greater than previously understood. We thus emphasize the difficulty of either party negotiating out all meaning of each of the terms of a contract, even if they individually care a great deal about the meaning of the term. Because the cost of time is often great and the likelihood of agreement unclear (given each party’s divergent views on the subject), the parties are likely to make the tradeoff between specificity of meaning and post-contracting negotiations and enforcement in favor of the latter. The cost of getting an agreement on a term may be too great, given the option of post contracting negotiations, so that even party who cares about the meaning of a term may not be able to insist on it.

### C. *Multiple Equilibria in Bargains*

Given the dynamics of bargaining and the range of tradeoffs the parties have to make, it is not surprising to see that negotiations often follow their own course and that the parties are choosing between several combinations of terms that would make each party better off. Consider the problem of multiple equilibria at play in a typical interpretation issue, using the *Hurst* case as an illustration.<sup>52</sup> There, the buyer agreed to buy horse meat and would get a discount when the protein content of the meat was “less than fifty percent” by weight. The literal meaning of “fifty percent” would be surplus-maximizing if both parties assigned that meaning to the term; that meaning would be reflected in the price term, allowing the price term to reflect the burdens and benefits the parties bargained for with that meaning in mind. On the other hand, the seller contended that “fifty percent” really meant that

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<sup>50</sup> See *infra* text accompanying notes 50–51.

<sup>51</sup> Kraus & Scott, *supra* note 16, at 1030. Kraus and Scott, however, find that the use of an express term is equivalent to the invocation of a rule that directs the court to “enforce the formal obligations.” *Id.*

<sup>52</sup> *Hurst v. W.J. Lake & Co.*, 16 P.2d 627 (Or. 1932).



the discount was not available until the protein content was below 49.5 percent because that was the term's meaning in the trade. That interpretation would also have been surplus-maximizing if that is what both parties had in mind as they bargained. The court has to choose between two potentially surplus-maximizing interpretations, but which one to choose depends on what one believes about the beliefs and expectations of the parties. When the terms are disputed, these are opaque to a court. And, of course, the problem is more intractable if the parties had no common meaning in mind. How does a court interpret the term if one party believed the term had one meaning and the other party believed that it had a different meaning?<sup>53</sup> Much is at stake. If the court selects the non-surplus maximizing interpretation, *prima facie* one of the parties has an unbargained-for gain and the other, an unbargained-for loss. Thus, the value of contracting will be reduced.

Notice several characteristics of this interpretive problem. The court is not seeking to identify the interpretation that is good for the contract system in general, or even an objective meaning that most contractors would attribute to the term in question.<sup>54</sup> It is seeking to determine the interpretation that is surplus-maximizing for the parties to this exchange. The court is examining the facts to determine what interpretation maximizes surplus for the exchange these parties negotiated.<sup>55</sup>

Second, notice that the surplus-maximizing interpretation depends on the interpretation of the disputed term, given the contract as a whole. Either interpretation could be surplus-maximizing if both parties understood the meaning

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<sup>53</sup> William F. Young, Jr., *Equivocation in the Making of Agreements*, 64 COLUM. L. REV. 619, 628–29 (1964) (using the case of *Raffles v. Wichelhaus* to demonstrate that “because the court can neither choose dispassionately between the understandings of the parties nor find a *via media*, frustration is inevitable”).

<sup>54</sup> Posner, *supra* note 4, at 1598–99 (using “objective” to mean: “to exclude a party’s self-serving testimony that cannot be verified because it concerns his state of mind or a conversation to which the only witness was the other party to the contract, and that party either denies that the conversation took place or disagrees about what was said”).

<sup>55</sup> Sometimes a court must interpret a term that is used frequently in contracts. If a court is interpreting a *force majeure* clause, for example, the court’s interpretation will influence how other contracting parties view the risks they are accepting in the contract, for it will be assumed that courts try to give consistent interpretations of standard clauses when they interpret contracts. Nonetheless, even the interpretation of standard clauses will depend on the circumstances that the parties faced and the way the parties addressed the risk of divergent meanings, which means that even the interpretation of a *force majeure* clause is a negotiation-specific enterprise. And parties may always craft their standard clauses in a way that fits the bargain they are making and the division of risks that they determined. Although a court’s method of interpretation should remain constant, the application of that method should be case-specific.

of the term in the same way. When there is common understanding, the parties adjust other terms of the contract to offset the burdens that one party takes under that meaning. That is the problem of multiple equilibria. If both parties expected that the discount would be given only if the protein content was below 49.5 percent (instead of the literal 50 percent), the exchange would be more valuable to the seller (because the discount would be given less often), and the seller would be willing to accept a lower price for the contract (other things being equal). If both parties meant that the disputed term allows the buyer to receive the discount when the protein content is less than the literal 50 percent, the exchange would be more valuable to the buyer (because the discount would be given more frequently) and the buyer would be willing to pay a higher price (other things being equal). If the parties understood the term in different ways, then one party must bear the risk of not identifying and clearing up the misunderstanding, and the court must choose which party bears that risk.

Because parties can adjust terms of the exchange to account for the risks from their exchange, it is not possible to determine *a priori* how the parties might have allocated risks *ex ante*. Although the parties would normally allocate risks to the party that can address them efficiently, that is not guaranteed. To see this, consider an individual who is contemplating paying for a license to use a particular trademark on jukeboxes.<sup>56</sup> Because the potential licensee plans to make asset specific investments that will increase the value of the trademark on juke boxes, she would prefer a license that can be revoked only for cause, and would want the contract to define cause in terms that she can control and that courts can easily verify.<sup>57</sup> That preference does not necessarily mean, however, that she will not take a license on different terms. Theoretically, if the royalty fee is lowered enough, she

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<sup>56</sup> See *Baldwin Piano, Inc. v. Deutsche Wurlitzer GmbH*, 392 F.3d 881, 882 (7th Cir. 2004).

<sup>57</sup> Information that is verifiable can be readily checked (like the combination of a safe). DOUGLAS G. BAIRD ET AL., *GAME THEORY AND THE LAW* 89 (1994) (“Legal rules governing information have to take into account whether verifiable or nonverifiable information is at issue” because “[c]ourts cannot sanction parties for breaching a duty to disclose information if they have no way of telling whether a disclosure is truthful.”).

“In the economics literature, a contract is complete when it differentiates among all relevant future states of the world, and a third party, such as a court, can verify, when necessary, which state has occurred.” Karen Eggleston et al., *The Design and Interpretation of Contracts: Why Complexity Matters*, 95 NW. U. L. REV. 91, 100 (2000). If a contract includes a clause that is contingent on an unverifiable state of nature, a contract is incomplete. *Id.* “In practice, much pay-off-relevant information is unobservable to one or more parties to a transaction or, even if observable, not verifiable by a third party, such as the court. Given these informational and verifiability constraints, most, if not all, real-world contracts are [incomplete].” *Id.*

may find it worthwhile to take the license at a lower price and self-insure against the risk of termination. The potential licensee may be faced with a choice between a high license fee with termination protection or a lower license fee with less termination protection. The licensor is faced with the mirror image tradeoff. The licensor will be willing to lower its licensing fee as its freedom to terminate the license increases; that reduces the possibility that the exchange will allow the licensee to injure its interests.

It could also be some combination that varies costs and investment-protection between those two poles. As a result, if the licensor's termination rights are disputed, it is impossible to say, without further analysis, whether the parties would choose "at will" termination for a low license fee or "for cause" termination for a higher termination fee (or something in between). Either interpretation is surplus-maximizing, depending on what one believes about the tradeoffs the parties made.<sup>58</sup> That is why courts need a methodology that allows them to examine the contract as a whole, and systematically determine whether one view of the tradeoffs the parties made is more probable than another.

This highlights a third characteristic of many interpretation cases—the court's interpretation will simultaneously determine the surplus-maximizing interpretation and how the parties agreed to divide the surplus created by the exchange. In the *Hurst* case, for example, the court cannot know how the parties agreed to divide the gains from trade because it cannot know whether the parties offset the burden to one of the parties (by making the discount less likely) with a burden to the other party (by lowering the price for the meat). The exchange is valuable to both parties in either event, but the court's choice of a surplus-maximizing interpretation will determine how much of the surplus goes to each party. It is no contradiction to point out that the parties would simultaneously maximize and divide surplus, nor that the goal of the parties was to maximize surplus while the goal of interpretation may be to determine how the surplus was to be divided. The two characteristics of the exchange—maximizing surplus and dividing surplus—are inevitable attributes

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<sup>58</sup> This assertion differs from the standard economic assertion that the parties will bargain toward a unique surplus maximizing exchange that reflects the minimization of costs. Under the standard economic model, the seller will agree to an obligation whenever the costs of that obligation are less than the benefits to the buyer, for that increases surplus. But that is not the comparison the bargaining parties make. As is implied by the Edgeworth Box, each party trades off its own interest in security and price, choosing between self-insuring (for a lower price) or getting greater contractual security (at a higher price). As our model of bargaining dynamics suggests, because the parties have different assessments of their costs of contracting, they bargain over multiple ways of addressing their individual interests in costs and benefits.

of the exchange. If the parties could have increased surplus with a different distribution of the surplus, one party would have paid the other to do so.<sup>59</sup>

A fourth and final characteristic of the interpretive problem is the court's difficulty in getting the information it needs<sup>60</sup> to determine the surplus-maximizing interpretation. Even if the parties had the same meaning in mind, one has an interest in hiding that fact once the interpretive dispute arises; neither party is an impartial spectator. If the parties bargained with different meanings in mind, the court needs a method of determining which meaning would be surplus-maximizing in the context of the deal the parties made. If we knew how the parties adjusted the price to take into account the surplus-maximizing interpretation, we could confirm that both parties adjusted their negotiating strategy to that meaning. But clear evidence of how the burdens of one interpretation caused the burdened party to seek an offsetting price adjustment will rarely be available. It is no wonder, then, that interpretation has focused on analytical proxies for direct knowledge of the price term adjustments the parties made.<sup>61</sup> In the absence of a better interpretive methodology of the kind we recommend, courts did the best they could.

### III. EVALUATING TEXTUALISM AND CONTEXTUALISM

Given the difficulties of interpretation that flow from the difficulty of knowing what tradeoffs the parties may have made, it is no wonder that courts have developed proxy rules to bring apparent order to their interpretive function. Although the academic debate between textualist and contextualist approaches is

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<sup>59</sup> Alan Schwartz and Robert Scott argue that bargainers will approach the negotiations as if the division of the gains of trade were exogenously determined, in which event (because the negotiations cannot change the division of the surplus) they would both act to increase the surplus. Schwartz & Scott, *supra* note 2, at 552–54. We do not challenge their analysis in this article, although we note that it is contextual. Even under an exogenously determined division of the surplus, the price term will reflect the division of the surplus. Because the interpretation is intended to determine the surplus maximizing terms, and because the price term can be adjusted to reflect different combinations of costs and benefits, the interpretation will determine both the surplus maximizing terms and the division of the surplus. As Schwartz and Scott say, “[p]arties jointly choose the contract terms so as to maximize the surplus, which the price [term] may then divide unequally.” *Id.* at 554.

<sup>60</sup> Schwartz & Scott, *Contract Interpretation Redux*, *supra* note 25, at 944 (highlighting the “comparative advantage” that the parties have over courts “in choosing the interpretive rules that best make this tradeoff because the parties are better informed than the state about the relevant costs and benefits”).

<sup>61</sup> Cohen, *supra* note 1 (stating that in determining interpretation, courts focus on proxies such as whether the contract is incomplete, the presence of opportunism, the superior risk bearer, and the parties’ hypothetical intent).

stimulating, we must ask whether either method provides a good proxy for the end the court is seeking, which is to determine the obligation of the parties under a surplus-maximizing interpretation.<sup>62</sup>

### A. General Considerations

Before examining specific claims in the academic literature, it is worth setting a framework for our analysis. Among the difficulties inherent in the debate between textualists and contextualists is the lack of clarity about the two methods of interpretation, for text can be understood with various kinds of contextual clues, which means that even textualism does not take a fixed form. Recall that even the most ardent textualist court will consider context when it finds the terms to be ambiguous, which means that no court believes that the text is a perfect proxy for the surplus-maximizing goal and that even textualist courts need some method of determining when and why context is relevant. That, in turn, requires a way of determining which of two alternative interpretations is surplus-maximizing, for only such a method can provide the information that a textualist court needs to determine whether to stick with the text or to consider the text in context. Contextualism is itself a poor proxy for determining the surplus-maximizing interpretation unless the court can determine what context matters and why. Both textualists and contextualists need a basis for determining what factors to examine, the textualists to determine when the term is ambiguous enough to take evidence about its meaning and the contextualists to make sure that contextualism is not an open ended and unguided exploration.

The methodology we recommend provides that understanding and therefore provides a better fit between the interpretive method a court uses and the surplus-maximizing end it is trying to reach. Our methodology sidesteps the ambiguity of the two conventional approaches by making the question of whether courts need a thin or a thick evidentiary base a part of the interpretive analysis.

In our view, the debate about the role of text and context in interpretation sometimes misses the distinction between means and ends. The goal of interpretation is to determine the obligations of the parties under the contract they concluded; it is not to control the way the parties design or articulate their contracts. If the court correctly identifies the party's obligations at reasonable cost, the court will decrease the cost of contracting by decreasing opportunism in contracting and enforcement. Interpretation is a necessary element of enforcement,

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<sup>62</sup> Kostritsky, *supra* note 43, at 114.

not a necessary element of contracting and the law has no interest in intervening to urge the parties to contract in one way rather than another or to set default rules of interpretation if the parties are not likely to even think in those terms.

Naturally, the parties will contract in the shadow of the law.<sup>63</sup> But negotiating in the shadow of the law means negotiating while knowing that the primary end of the law is to require the parties to keep their obligations and to avoid allowing one of the parties to get unearned benefits. However, negotiating in the shadow of the law is best if the law aims to find the surplus-maximizing deal the parties actually made. It is for that reason that parties should not be forced to negotiate over which interpretive rule to select. Moreover, once the parties see courts using a methodology that identifies their surplus-maximizing obligations, they would not anticipate that courts would need interpretation instructions.<sup>64</sup>

We also dispute the notion that parties will routinely choose better interpretive rules than courts do. We dispute that assertion because we do not believe that interpretation should revolve around rules and because parties will omit any interpretive choice that is meaningful to a court. Appropriate interpretation provides the parties with an incentive to keep the promises made in the exchange, not with an incentive to contract in one way rather than another.

Indeed, our method of interpretation follows the wisdom of Alan Schwartz and Robert Scott, themselves textualists, that:

There would be no need for defaults or interpretive instructions (from parties to courts) if two premises were satisfied: first, the state's goal is to maximize the parties' expected profits; and, second, the state is as capable of doing so as the

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<sup>63</sup> See, e.g., Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950, 950 (1979) (drawing attention to the way in which divorce law acts “as providing a framework within which divorcing couples can themselves determine their postdissolution rights and responsibilities”).

<sup>64</sup> The goal of contract interpretation rules is to find the surplus maximizing interpretation while minimizing transaction costs. Party choice proponents argue that, as a default, courts should perform textualist interpretations. If parties want a broader interpretation they should clearly state that in their contracts. However, “[p]arties often use words believing that they have identified the object of contracting with enough particularity that they never anticipate that a term will require interpretation and often see no need for party choice.” Kostritsky, *supra* note 17, at 246. Thus, the assumption that parties who want a broad interpretive technique will broadcast it to the courts is flawed. Therefore, because interpretation instructions will often be opaque, having a method that will avoid the need for parties to actually instruct courts and avoid the risk that court will misread their instructions would be beneficial in fact. *Id.* at 246.

parties. Then the state could adopt optimal interpretive rules [or methods]. These rules [or methods] would direct the court to broaden the evidentiary base when this would maximize the parties' expected utility and to narrow the base when that would be best. Parties would anticipate that courts would interpret disputes according to these rules [or methods] and thus would not issue interpretive instructions (there is no need to instruct a perfect agent.).<sup>65</sup>

Our methodology does that.

### *B. Evaluating Claims About Textualism*

Because we offer our methodology as a way of assisting courts in improving the proxy methods they now use, it is helpful to isolate the characteristics of textual and nontextual interpretation that make them poor proxies for determining the surplus-maximizing interpretation.<sup>66</sup>

To examine whether textualism is a good proxy for the surplus-maximizing interpretation, we evaluate three claims about textualism that appear in the economics literature: (1) the claim that textualism is less costly than contextualism; (2) the argument that contracting parties generally would prefer a textualist approach; and (3) the claim that even erroneous textual interpretations will have the long-run benefit of inducing the parties to invest more in negotiating their exchanges and articulating the terms of the bargain.

#### 1. The Claim That Textualism Is Less Costly Than Contextualism

Textualism appears to be less costly than contextualism because textualism conserves on litigation costs.<sup>67</sup> Textualism's benefits appear great when compared

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<sup>65</sup> Schwartz & Scott, *Contract Interpretation Redux*, *supra* note 25, at 942 (footnote omitted).

<sup>66</sup> Because our argument is that judicial interpretation ought not be governed by rules but by a methodology of interpretation, we agree with Alan Schwartz and Robert Scott that giving effect to the parties' deal is paramount and that sometimes current approaches such as an invariant rule of contextualism or an emphasis on contractual ends may misdirect courts away from the parties' deal. *See* Schwartz & Scott, *Contract Interpretation Redux*, *supra* note 25, at 926.

<sup>67</sup> *See* Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814 (2006). Scott and Triantis detail the tradeoffs between front-end (transaction) and backend (enforcement) costs. *Id.* at 823. They argue that parties make deliberate tradeoffs, sometimes choosing to leave contracts less complete with reduced drafting costs and at other times investing more in drafting. The parties "continue to invest in contracting costs until the marginal cost of further investment exceeds the marginal benefit in incentive gains." *Id.* There is an implicit assumption that more drafting now saves on litigation costs later. *See id.*

with the costs of open-ended or misused contextualism, although we believe that they would be reduced when compared to the methodology we offer.<sup>68</sup> Moreover, the resource savings of textualism will be offset if the resulting interpretation is not surplus-maximizing—that is, if a textualist court cannot identify the opportunistic use of the contract’s text.<sup>69</sup> Textualism invites *ex post* opportunism, as we can illustrate using the *Hurst* case. If both parties intended that the discount would be available when the meat had a protein content of 49.6 percent (notwithstanding the literal meaning of the “fifty percent” term); textualism allows the seller to seek unearned benefits by advocating a literal meaning for the contract. A seller who agrees to provide the discount when the protein content is 49.5 percent gets the benefit of promising to make the discount more readily available, but can then turn around and try to limit the discount through a textualist interpretation.

Finally, the costs of textualism include not only cases wrongly decided but cases that could have been disposed of easily if a party had not had a facially plausible but substantively empty claim. Many appellate courts spend considerable time reviewing textualist interpretations that have only the flimsiest justification when evaluated on the basis of surplus maximization. In short, textualism makes difficult many cases that would, if context were efficiently taken into account, be easy.

As for contextualism, it need not be as expensive as its critics claim. Because context is not clearly defined in the literature, it takes on a ghostly and outsized apparition. To be sure, it includes information about pre-contractual matters such as the context of negotiations, preparatory communications or notes,<sup>70</sup> prior dealings between the parties, and prior dealing of the parties individually in the relevant trade or business sector. It also includes post-contract information about how the parties manifested their understanding of the exchange in post-contractual performance and discussions. These important sources of information imply expensive trials about hotly contested factual issues. But, in our view, context also provides the court with information that is likely to be uncontested or inexpensive

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<sup>68</sup> Katz, *supra* note 7, at 496 (directing his insights on contract interpretation to private parties rather than courts on the theory that they can make better use of economic insights). But we argue in this article that courts can make use of such insights when they are embedded in a clear methodology geared to identifying the surplus maximizing interpretation.

<sup>69</sup> The dangers of textualism in one of its many forms have been noted by Macaulay, *supra* note 8, at 37–39.

<sup>70</sup> Judge Posner would avoid utilizing these types of evidence due to the likelihood that they could be self-serving. *See* Posner, *supra* note 4, at 1600.



to obtain. This includes information about each party's private projects, the way each party supplies inputs to help the other party meet *its* private projects, and information about which party was in the best position to avoid interpretive disagreements.<sup>71</sup> This kind of contextual information is not likely to be expensive to uncover or evaluate because most of it involves uncontested information that gives rise to no triable issues. What is at issue in many interpretive cases, as will become clear from the methodology we recommend, is how courts ought to evaluate non-contestable facts in order to determine the obligations the parties accepted.

When courts focus on the kinds of information they need to determine which interpretation is most likely to be surplus-maximizing, courts will be able to more adequately understand *why* usages of trade and course of dealing are relevant and will thereby be able to focus on the aspects of these extrinsic tools that are most relevant to the interpretive issue they face. Usages of trade and course of dealing provide information about how parties in relevant contexts normally divide risks and use various terms. Once courts understand the information they need to decide the interpretive question they face, as they will under our methodology, they will be able to exploit these extrinsic sources efficiently and accurately.<sup>72</sup>

Hence, we believe that once the role of context in interpretation is properly understood, courts will find that context can be considered without expensive trials. Contracts serve economic functions and by understanding those functions courts will understand how the parties set up the exchange to get the most from the exchange. Understanding each party's goals, motivations and likely decision making processes allows courts to understand, using the methodology we recommend, which interpretation relies on empirical claims that are likely to be true and which rely on empirical claims that seem too farfetched to be true without a strong evidentiary foundation.

## 2. The Claim That Parties Prefer Textualist Interpretations

It has also been suggested that contracting parties generally want courts to adopt a textualist method of interpretation, so that textualism ought to be the default rule. Contracting parties with a different preference should opt out of a

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<sup>71</sup> Schwartz & Scott, *Contract Interpretation Redux*, *supra* note 25, at 936.

<sup>72</sup> Again, the *Hurst* case provides an example. As we elaborate below, if both parties were seasoned members of the trade, it would take a very strong evidentiary base to convince the court that the parties did not adopt the meaning of the term used in the trade. *See infra* notes 87–90.

textual interpretation, which is said to give the parties control.<sup>73</sup> We agree, of course, that parties should control the terms of their exchange. Our point is that they have ample means to do that by the contract they draft and that proper interpretation will honor party control. Merger clauses, definitions, and specific obligation clauses signal to the court that the parties have addressed a range of potential disputes *ex ante*. Courts will respect the way the parties have limited the court's discretion because that is the best way of protecting the surplus-maximizing contract. But even discretion-limiting devices need to be interpreted, which means that courts ought not reflexively resort to one party's claimed interpretation. Discretion-limiting devices are adopted by the parties with contextual assumptions in mind. When the interpretive issue arises in different contexts, the court must determine whether the discretion-limiting device applied in that context. Even as they give deference to the interpretation indicated by discretion-limiting devices, courts must address a party's claim that invocation of the discretion-limiting device would not be surplus-maximizing.<sup>74</sup> Moreover, because we believe that interpretive default rules ought to give way to our structured methodology, we find the debate about default rules to be irrelevant.<sup>75</sup>

Asking the parties to select a method of interpretation is likely to be wasteful. Neither party knows *ex ante* which portion of the text will give rise to an interpretive problem. Depending on the words and context from which the dispute arises, one party will want a textualist interpretation in one setting (the setting in which that party used the words in their plain meaning) but not in another setting (where the party used words with a specialized meaning in mind). It is not likely that either party would want to bargain over an interpretive methodology without knowing its effect on the deal the party thought it was making. Moreover, to ask the parties to negotiate over *both* the terms of the exchange and also over an interpretive method adds to the cost of negotiation and could possibly result in no contract at all. Because, as we have already argued,<sup>76</sup> neither textualist nor

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<sup>73</sup> Schwartz & Scott, *Contract Interpretation Redux*, *supra* note 25, at 939.

<sup>74</sup> *See* Am. Research Bureau, Inc. v. E-Systems, Inc., 663 F.2d 189, 198–200 (D.C. Cir. 1980).

<sup>75</sup> It may well be, as Schwartz and Scott argue, that “[b]usiness firms are content with interpretations of their language that is correct on average, not always correct, and so prefer a narrow evidentiary base to a broad one.” Schwartz & Scott, *supra* note 2, at 589. We would hope, however, that they have higher aspirations than that, and this assumption about the preference of business terms reflects the false choice between a cheap textualist analysis and an expensive contextualist analysis. We believe that businesses would prefer to reduce the error rate if that can be done at reasonable cost, which our methodology does.

<sup>76</sup> *See supra* text accompanying notes 50–52.

contextualist interpretations result in predictable outcomes, it is probably not worth the time and expense to either party to negotiate over a method of interpretation.<sup>77</sup> Most importantly, however, what both parties desire *ex ante* is an interpretive judicial methodology that protects the surplus by correctly interpreting the terms of the deal in the context in which they made it;<sup>78</sup> any other methodology risks decreasing the contractual surplus and thus impairing the institution of contracting. Our methodology gives the parties what they desire.

### 3. The Claim That Even Erroneous Textual Interpretations Will Have Long-Term Contracting Benefits

It has also been suggested that *erroneous* textualist interpretations will induce the parties to invest more in negotiating, with long-term benefits for the institution of contracting as parties reduce domains of potential disagreement. But our analysis of the bargaining relationship shows why courts ought not intervene to force contracts to be more fully specified. Not only are many interpretive issues often invisible to the parties, but the parties are not concentrating on what might go wrong in their deal but on whether they have enough assurance that things will go right to justify them in contracting. Often the real negotiation occurs only over three to four issues which are deal breakers. Knowing that courts sometimes get non-surplus-maximizing interpretations from a textualist analysis does not aid the parties in their contract drafting, for it is difficult to draft around erroneous interpretations of text when the court should have understood the meaning of the text in a contextual, not literal, sense.

The argument for erroneous textual interpretations misunderstands the incentive goal of interpretation. As we have argued, one party in the negotiation is in a superior position to avoid future disagreements and interpretation ought to focus on providing an incentive for that party to avoid acting opportunistically *ex ante*. Aside from that incentive goal, the goal of interpretation is to get the parties to keep the promises that are surplus-maximizing in the context of the exchange the parties made. More importantly, the supposed advantages of an erroneous textual interpretation disappear once we understand that there can be a non-erroneous

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<sup>77</sup> At bottom, our view is that the search for party preferences, like the search for the parties' intent, is chimerical. *Ex ante*, the parties' preference is for an interpretation that mitigates opportunism and identifies the obligations that maximize surplus; *ex post*, the parties' preferences, like their interests, diverge.

<sup>78</sup> Correctly interpreting the terms in the context in which they made their deal requires a realist understanding of how the parties bargain, including whether parties are likely to expressly choose interpretive methods in contract formation. See generally Kostritsky, *supra* note 17.

surplus-maximizing account that minimizes the cost of negotiating to avoid interpretive risk.

To be sure, the eagerness of the contracting parties to avoid interpretive risk should induce them to continue to negotiate until they have specified, to the extent possible, their obligations in all future states of the world, but they hardly need the incentive of erroneous judicial interpretations to do so. Inducing them to invest more in specification than they naturally would is paternalistic and costly. Moreover, the argument in favor of erroneous textual interpretations is perverse in suggesting that a party to a contract should give up a bargained-for benefit in order that *other* parties will invest more in negotiation. Contracting parties deserve a surplus-maximizing interpretation and ought not become the means of misguided social engineering.

In short, when weighing the relative merits of textualism and contextualism, it is important not to confuse the method of interpretation with the question of how the court gets the information it needs to make the interpretation. Asking a court to choose between methods of interpretation seems to confuse the substantive with the epistemological—the question of what we want to know with the question of how we get the information to know what we want to know. The interpretive goal is to determine the obligations of the parties. It is relevant to do that with an eye to making the determination efficiently, too be sure, but resources can be saved if the court makes a rational assessment of the probable accuracy of the empirical claims that are necessary to make a claimed interpretation a surplus-maximizing interpretation. The methodology we describe in the next section does that.

#### IV. OUR METHODOLOGICAL APPROACH

Because no hypothetical, ideal bargain or bargaining generalization can capture the dynamics of particular bargaining relationship or identify the equilibrium point that the parties in a particular bargaining relationship have chosen, courts must analyze the particular exchange before them to identify the obligations that best reflect the terms the parties have agreed on and the information the parties had about the terms they used in the exchange. Such a methodology will attend to the language the parties used, the general proclivity of bargainers in similar situations, and the context of the bargain. But courts will not start with any prejudgments about the weight those factors ought to be given. Instead, they will incorporate information and assumptions about general

bargaining strategies into their analysis by determining what weight to give them in the context of the particular parties and the exchange they made.<sup>79</sup>

Because we cannot assume that the parties had similar expectations about their respective obligations, courts must separately evaluate the interpretations the two parties offer to determine which interpretation is most likely to be surplus-maximizing *ex ante*. This evaluative process requires two steps:

1. A court must identify, for each of the interpretations offered by the parties, the determinants that would make that interpretation surplus-maximizing.
2. The court must decide whether there is a reason to try the empirical claims that are the determinants of each party's interpretation.

This process separates the question of what empirical claims each party is advancing from the question of what body of information the court uses to test the validity of those claims.

*A. Step One: Identifying the Surplus-Maximizing Determinants*

To implement the first part of this methodology, the court should ask each party to articulate their interpretation of the relevant terms of the contract and to identify the determinants of their interpretation that would make the exchange surplus-maximizing *ex ante*.<sup>80</sup> That is, the court will ask each party to identify the empirical claims that would have to be true for each interpretation to be surplus-maximizing in the context of the private projects of each of the parties and the terms not in dispute. Each of the competing interpretations has associated with it a set of empirical claims that are necessary to make the interpretation surplus-maximizing. By identifying and evaluating those empirical claims, the court can choose the interpretation that best enhances the *ex ante* surplus generated by the contract, which is synonymous with the interpretation these parties would have agreed upon *ex ante* had the interpretative question been raised and addressed. The two statements of the empirical claims that must be true for an interpretation to be

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<sup>79</sup> In other words, the court will take into account the sophistication of the bargainers and the complexity of the exchange when analyzing the exchange the parties made and the probability that the exchange implies one obligation rather than another. But these factors will be evaluated as the context identifies them and will not form a set of pre-existing rules that the parties must have in mind while bargaining.

<sup>80</sup> See Mitchell N. Berman & Kevin Toh, *Pluralistic Nonoriginalism and the Combinability Problem*, 91 TEX. L. REV. 1739, 1745 (2013) (suggesting the idea of displaying the determinants of a statement to test its validity).

surplus-maximizing form two competing hypotheses. The empirical claims that must be true for one of the hypotheses to be true form a kind of decision tree because once the parties identify the determinants the judge can ask the parties what must be true for those determinants to be true.<sup>81</sup>

Take, for example, a variation on the issue that Justice Cardozo faced in *Jacob & Youngs, Inc. v. Kent (Reading Pipe)*.<sup>82</sup> There, the contract called for Reading Pipe and the contractor installed (allegedly) equivalent pipe from a different manufacturer. The homeowner's interpretation (that the contractor was obligated to use genuine Reading Pipe) would have been surplus-maximizing if (a) the homeowner cared about the source of the pipe rather than the type of pipe and (b) the contractor knew or should have known of that preference. Under that set of empirical claims the parties would have used the price of genuine Reading Pipe to determine the price of the house and the buyer should get what it bargained for. This would be surplus-maximizing because the supplier would be compensated for the cost of the very thing the buyer valued.

The contractor's view, on the other hand, was that (a) the buyer cared about the quality of the pipe but not the source of the pipe, and that (b) the buyer left it up to the contractor to choose the pipe that met the buyer's quality needs at the lowest price. The contractor's interpretation would increase surplus by allowing the homeowner to rely on the contractor's expertise to reach the homeowner's

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<sup>81</sup> The idea of using a decision tree to analyze complex phenomena comes from Ricardo Hausmann et al., *Growth Diagnostics*, INTER-AMERICAN DEVELOPMENT BANK 8, 28 (Mar. 2005), <http://www6.iadb.org/WMSFiles/products/research/files/pubS-852.pdf>. We employ the decision tree in the following way. At the top of the decision tree is a statement of the interpretation urged by a party. This is followed by a statement reflecting why that interpretation is asserted to be surplus maximizing. At the next level of the decision tree, the court asks: what empirical claims must be probable for the asserted interpretation to be surplus maximizing? Those empirical claims are the determinants of the surplus maximizing interpretation because they determine whether the interpretation is, in fact, surplus maximizing. To identify the determinants, the court is asking: If Party A's interpretation is surplus maximizing, what empirical claims must be true for us to accept the interpretation? At the next level of the decision tree each of the determinants of the proffered interpretation will then have empirical determinants that tell us whether *those* determinants are empirically plausible.

<sup>82</sup> 129 N.E. 889 (Ct. App. 1921) (questioning the remedy when the breach was negligent, not willful, and when the cost of correcting the breach greatly exceeded the lost market value from the breach). For a comprehensive analysis of the case, see Victor P. Goldberg, *Rethinking Jacob and Youngs v. Kent*, Columbia Law School Working Paper 510, Feb. 20, 2015, available at <http://ssrn.com/abstract=2567950> (2015). Interestingly, the interpretive issue that we discuss in the text was seemingly addressed in paragraph 22 of the contract, which provided that: "Where any particular brand of manufactured article is specified, it is to be considered as a standard. Contractors desiring to use another shall first make application in writing to the Architect, stating the difference in cost, and obtain their written approval of the change." *Id.* at 4.

specified quality. The contract would be surplus-maximizing because the buyer would pay, and the seller would charge, no more than the price required to get the desired level of quality.

These two versions of the particular bargaining relationship boil down to the question of whether it is likely that the homeowner cared about the source of the pipe rather than the type of pipe, and whether the seller knew, or should have known, of that preference when quoting a price for the contract. The following possible scenarios describe the determinants of the relevant surplus-maximizing interpretations:

1. The homeowner had a preference for genuine Reading Pipe and communicated that to the contractor.
2. The homeowner had a preference for genuine Reading Pipe and the contractor should have known of that preference, either by asking about it or by knowing from her experience (usage of trade) that homeowners generally care about this detail.
3. The homeowner had a preference for genuine Reading Pipe but the contractor could not reasonably have known about it unless the homeowner expressed a preference.
4. The homeowner did not have a preference for genuine Reading Pipe and left it up to the contractor to get pipe of the requisite quality.

These four propositions display the determinants of a surplus-maximizing interpretation. They also show the importance of evaluating which party should have come forward during the bargaining process to identify a possible misunderstanding. Each party has information about its preferences and the likely preferences of the bargaining partner. One of the parties, because of experience or the ability to investigate the facts (perhaps by discussing the facts with the other party), has superior access to term-clarifying information. Interpretation functions not only to determine what factual scenario most probably represents the trade-offs the parties made also to determine which party was in the best position to avoid the interpretive dispute—the party we call the least cost information gatherer.

This methodology allows the court to identify which party was the least cost information gatherer and therefore, by its interpretation, to reward bargaining parties that provide exchange-enhancing information or to punish bargaining parties that withhold exchange enhancing information. Proposition (1) asserts that the buyer knew that the contractor would assume that the buyer would not care about the source of the pipe (so that the buyer had the burden of communicating her specialized information to the seller), whereas Proposition (2) asserts that the general presumption about preferences is sufficiently ambiguous that the

contractor, being the repeat player in the trade (and therefore the low cost information gatherer) should have inquired about the precise nature of the buyer's preferences. Proposition (3) shows the consequences if the buyer should have known that the seller would not know of a specialized preference and fails to meet the buyer's burden of informing the seller.<sup>83</sup> Proposition (4) suggests that the buyer is acting opportunistically by asserting a preference that did not, in fact, exist. In other words, the court must determine whether the homeowner or the contractor should have raised the issue of the customer's preferences, which it does by deciding which party was in the best position to know of the potential ambiguity and seek to address it. The party that should have raised the ambiguity, but did not, is bound by other party's justified interpretation.

*B. Step Two: Determining Whether There Is a Reason to Try the Empirical Claims That Support Each Party's Interpretation*

Once the surplus-maximizing determinants of each interpretation have been identified, the court must assess the probability that each of the determinants accurately reflect reality. At this stage, the court resorts to probabilistic analysis to determine whether it can rule out any determination on a dispositive motion or whether to assign one of more of the competing empirical claims to the fact-finding process.<sup>84</sup>

Observe the role of dispositive motions in reducing the cost of interpretive litigation in our *Jacob & Youngs* example. The possibilities track the outline of relevant facts we have already articulated. If the court is willing to entertain the presumption (based on the court's own experience or direct testimony)<sup>85</sup> that most homebuyers do not have a brand preference but only a quality preference (or if the parties do not contest that proposition), the court can reject Proposition (1) unless the buyer had communicated a specific preference for Reading brand pipe. That

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<sup>83</sup> Proposition (4) suggests that the buyer is acting opportunistically by claiming a preference that did not, in fact, exist.

<sup>84</sup> The effect of our methodology is to disaggregate the bargaining position of the parties to reflect their divergent, rather than joint, positions. Although this distinguishes our approach from that of Listokin, the use of probabilistic, Bayesian decision-making to focus the disaggregated issues is consistent with his recommendations. *See generally* Listokin, *supra* note 10.

<sup>85</sup> For example, the defendant contractor might submit affidavits from other contractors that homeowners only rarely care about the source of the pipe and that when they do they make that preference clear. If those affidavits are uncontested, as they are likely to be, the question of the buyer's burden of making his special preferences known would be clear, and the only question left in the case is whether the buyer in fact had special preferences and reasonably communicated them to the contractor.



might be the case if the buyer could plausibly assert that she had specialized knowledge of pipe or had some pre-existing relationship with the Reading Pipe company, in which case this particular fact, if adequately proven or not contested, would justify a judgment for the buyer. Proposition (2) addresses the possibility that customer-preferences for a particular brand of pipe are known to be sufficiently strong that the court believes that the contractor should have clarified the buyer's preferences before pricing the contract. Then the contested facts would be about whether the contractor clarified the situation to avoid the ambiguity and acted in accordance with that clarification.<sup>86</sup>

Proposition (3) covers the situation in which the buyer had a preference for the specific brand of pipe but did not communicate that preference to the seller; if the court believes that both seller and buyer knew that a preference for a particular brand was idiosyncratic, the court can put the burden on the buyer to make its idiosyncratic preferences known. The final situation is one in which the buyer had no preference for a brand of pipe and therefore cannot maintain a claim against the seller if the seller used the requisite quality of pipe.

Significantly, this methodology enables courts to avoid relying on the generalities that now plague interpretation. Rather than asking what most parties would expect in the *Reading Pipe* context and ruling accordingly, a court would make a rule on the basis of a case-appropriate presumption that can be countered with particular evidence from the case before it. Rather than looking for the intent of the parties, the court would be looking for the bargaining party—the least cost information gatherer—who had the greatest opportunity to make sure that there could be a meeting of the minds on the disputed term. This methodology focuses on what each party is most likely to have had in mind when using the term Reading Pipe and using the interpretation to force the party who could identify the ambiguity at lowest cost to do so. This methodology therefore leaves room for the buyer with special preferences to contract for them but reduces the chance that a buyer who was unhappy with some other part of the performance would use the source of the pipe as an excuse for getting a price reduction.

Let us now explore two additional cases, one that requires a court to give the correct interpretation of a term and the other that requires a court to evaluate how the parties have divided risks between them.

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<sup>86</sup> One can well imagine, for example, that if the issue was whether the buyer preferred Formica or granite countertops, the contractor would know to ask the buyer for their preference before pricing the contract.

### 1. *Hurst* Illustration—Interpreting a Term

Returning to the *Hurst*<sup>87</sup> case as an example, if the negotiating parties used a term in the same way, the common usage would be surplus-maximizing because the parties would have negotiated with that meaning in mind, adjusting the other terms of the deal in light of that meaning. As a preliminary matter, the court can set up two possible surplus-maximizing interpretations based on that common understanding. The buyer's interpretation would be surplus-maximizing if both parties used the term 50 percent to mean 49.5 percent or more, and the seller's interpretation would be surplus-maximizing if both parties used the term 50 percent in its literal sense.

That is not the end of the analysis, of course, for the parties might have assigned different meanings to the disputed term. If the parties did not negotiate with the same meaning in mind, the court will ask whether one party was more likely than the other party to have known that its counterparty negotiated with a different meaning in mind. By identifying which party had superior knowledge of the divergent meanings, the court can conclude that the party with superior knowledge either did not care which meaning was given the term (in which event the other party's meaning would be surplus-maximizing) or did not come forward to clarify the situation because they thought they could use the disparity to their private advantage. Either way, the party with superior knowledge of the misunderstanding should have clarified the misunderstanding; if that party did not come forward that party has provided a reason for rejecting that party's interpretation.<sup>88</sup>

We concluded above that for the buyer's interpretation to be surplus-maximizing, one would have to believe that the buyer thought of the term "fifty percent" in its specialized meaning (that is, any protein content less than 49.5 percent) and either (1) that the seller thought of the term in its specialized meaning or (2) that the seller generally used the term in its literal meaning but acquiesced in the buyer's specialized meaning. For these empirical statements to be true, one would have to believe that (a1) the seller generally used the term in its specialized

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<sup>87</sup> *Hurst v. W.J. Lake & Co.*, 16 P.2d 627 (Or. 1932).

<sup>88</sup> This is the information-forcing function of interpretation. Courts should adopt the meaning that forces the party with superior information about the divergent meanings used in the negotiation to identify the divergence or to accept the other party's meaning. Doing so reduces transaction costs by reducing the opportunism that can arise from asymmetric information.

meaning (in which event we can assume, unless rebutted, that the seller adopted the specialized meaning) or that (b1) the seller knew or should have known that the buyer had a specialized meaning and (b2) acquiesced in the specialized meaning. Evidence about the seller's knowledge of trade usage would determine whether (a1) is a plausible empirical claim; the court can accept it unless the seller disputes it. Explanation (b1) would be a plausible empirical statement if the buyer told the seller of its specialized meaning or if the seller should have known of the buyer's specialized meaning. Statement (b2) would be a plausible empirical statement if the seller was compensated for giving the discount more often, if the seller was willing to sell the meat for the same price under either the term's literal or specialized meaning,<sup>89</sup> or if the seller wanted to create an ambiguity (and later claim that plain meaning of the term applied).

As for the seller's interpretation, we saw above that the interpretation would be surplus-maximizing if the seller thought in terms of its literal meaning and (1) the buyer shared the same meaning or (2) the buyer did not share that meaning but acquiesced in the seller's literal meaning. For (1) to be a plausible empirical claim the court would have to believe that (a) buyer and seller both used the literal meaning in their other deals (which evidence of the usage of trade would help demonstrate). For (2) to be plausible the court would have to believe that (b1) the buyer knew or should have known of the seller's literal meaning and (b2) that the buyer acquiesced in the seller's literal meaning. Statement (b2) would be plausible if the buyer acquiesced because the buyer wanted to create an ambiguity (and later claim that the specialized meaning applied) or if the buyer was indifferent as to the two meanings or was compensated for acquiescing in the seller's meaning of the term.<sup>90</sup>

Once the judge has identified the relevant empirical claims, the judge should, as the second step of the process, determine whether any of the empirical claims that are necessary to establish the surplus-maximizing interpretation need to be tried. Each of the necessary determinants has a probability associated with it and the probability can be updated by examining the evidence that each party offers to strengthen or refute the validity of the claim. More generally, when both parties are experienced members of a trade, it would be difficult for the buyer to argue that the seller should have thought that the buyer would be insisting on a literal

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<sup>89</sup> The seller might allow the ambiguity to exist if the seller thought that determination of protein content might yield a larger discount at the literal meaning than at the specialized meaning.

<sup>90</sup> It is not clear why the discount would vary with such a small difference in the protein content.

interpretation (and thus increase the likelihood of a discount) when such an interpretation would be contrary to the generally prevailing usage of the term. Under these circumstances, for the literal meaning to be priced into the deal, it would seem incumbent on the buyer to alert the seller that the discount would not be available under the usual terms so that the seller could take the appropriate precautionary steps or price the deal accordingly.<sup>91</sup> Without that specific notification, the seller would be justified in pricing the contract on the basis of the specialized meaning of the term and the court would be justified in giving summary judgment to the seller. Rookies are held to the same standard as established dealers so it does not make sense to say it is incumbent on sellers to notify the buyer of the specialized meaning. The policy reason for holding rookies to the same knowledge/standard as those more familiar with trade usages is to make sure that rookies learn the usages/practices right away.

## 2. *Midwest Television* Illustration—Determining the Lowest Cost Risk Bearer

A second type of interpretation case involves the allocation of implied risks (rather than the interpretation of particular terms). In that kind of case, the surplus-maximizing interpretation is the one that accurately assesses how the parties must have allocated the risks, given each party's ability to minimize or insure against the risk and the possibility that one party compensated the other party for accepting the risk. By examining which risks are at stake in the dueling interpretations, the court can ascertain which empirical claims about the allocation of risk must be true for the risk to have been allocated in one direction rather than another.

We illustrate this with a garden variety dispute, *Midwest Television Inc. v. Scott, Lancaster, Mills & Atha, Inc.*<sup>92</sup> The defendant advertising agency bought advertising time on the plaintiff's television station on behalf of an advertiser. When the advertiser went bankrupt, the television station sued the advertising agency, which defended by claiming that it had bought the advertising time as the agent for the advertiser, its principal, and that because the television station knew the identity of the advertiser the television station could look only to the advertiser, and not the advertising agency, for payment. The interpretive issue was whether, as the ad agency claimed, the television station had accepted the risk of the advertiser's nonpayment—that is, whether the ad agency's obligation to pay the television station was contingent on being paid by the advertiser?

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<sup>91</sup> U.C.C. § 2-202 cmt. 2 (2013).

<sup>92</sup> 252 Cal. Rptr. 573 (Cal. Ct. App. 1988).

The ad agency argued that the television station bore the risk of nonpayment, a position that was supported by the *Restatement of Agency*, which provided that if the agent disclosed the name of the principal then the agent was not responsible for the principal's nonpayment. The television station argued that, the *Restatement* notwithstanding, the ad agency bore the risk because that was consistent with trade usage. On its face, the case seemed to pit the *Restatement* against trade usage.<sup>93</sup>

Although the contract between the ad agency and the television was silent on the issue, once a court understands that the parties had to allocate the risk of the advertiser's nonpayment, it can see that the competing interpretations would deal with the question of risk allocation. The parties would either allocate the risk to the low cost risk-absorber or the low cost risk-absorber would pay the other party to bear the risk. On this basis, the parties would formulate the two surplus-maximizing hypotheses as follows.

1. The advertising agency agreed to bear the risk of the advertiser's nonpayment if (a) the advertising agency is the low cost risk-absorber and (b) the advertising agency did not pay the television station to take the risk.
2. The television station agreed to bear the risk of the advertiser's nonpayment if (a) it is the low cost risk absorber (contrary to our earlier assertion) and (b) if it did not pay the advertising agency to take the risk.

These two surplus-maximizing interpretations point to the empirical claims that the court would have to explore to accept an interpretation as surplus-maximizing. The claims are mirror images of each other.

To determine which interpretation is surplus-maximizing, a court must identify which party is the least-cost risk bearer. One party will be able to monitor, adjust to, and insure against the risk better than the other.

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<sup>93</sup> The court decided that the bargain between the advertising agency and the television station was controlled by usages of trade and that usages of trade revealed that advertising agencies were generally responsible for the money owed by their client to the television station. *Id.* at 579. It also decided not to apply the *Restatement of Agency* approach, which created a presumption that the agent is not responsible for non-payment by the principal when the agent reveals the identity of the principal to the counterparty, which was surely true in this case. The court called the *Restatement* rule only a presumption, one that could be overcome by evidence of custom or usage of trade. *Id.* Although the court reached the correct result and was justified in relying on the usage of trade, we illustrate our methodology in the context of this case in order to show why it was appropriate to conclude that the usage of trade was in fact surplus maximizing.

In the advertising industry it is clear why the advertising agency, not the television station, can best address the risk of the advertiser's non-payment. The advertising agency has a relationship with the advertiser and can adjust to the risk in its contract with the advertiser. This arrangement facilitates payment to the advertising agency, for the advertiser pays the ad agency and the agency deducts its fee and forwards the difference on to the television station. Moreover, in *Midwest* the ad agency's contract with the advertiser, which the ad agency drafted, required the advertiser to pay the ad agency even before the advertisement was run so that the ad agency could promptly pay the television station. The advertising agency got the time value of money until they paid the television station. Finally, the contract specified that ad agency would not be financing the advertising services that the advertiser—the client—bought.

For these reasons, the advertising agency appeared to be the low-cost risk bearer, which allows us to presume that the parties would have placed the risk of the advertiser's nonpayment on the advertising agency unless the advertising agency paid the television station to bear the risk.

If the risk was shifted to the television station, the television station would have had to cover the cost of that risk, which it could do by agreeing to pay the television station more for the advertisements on which the television station took the risk. Although an ad agency might find that additional payment to be surplus-maximizing under some (narrow) circumstances (especially if the ad agency had private information about the risk), shifting the risk would require the ad agency to decrease its profit or become less attractive to clients and potential clients (because of the higher prices). Moreover, because television advertising is usually purchased on the basis of a published price schedule, it is easy to compare the price this advertising agency paid with the price in the schedule to see whether, in fact, the advertising agency had paid more to avoid the risk that would ordinarily maximize surplus. If, in fact, the risk shifted away from the low cost absorber, there would be evidence that the advertising agency could produce.

Our structured methodology also shows why the *Restatement* approach was disregarded in this case. Although the *Restatement of Agency* creates a presumption that an agent shifts the risk of nonpayment to the buyer when an agent discloses the principal's name to the buyer, that presumption could not apply in this case. The ad agency functioned as a broker, not an agent, and, in any event, the presumption is overcome here because the information sharing was a necessary part of the purchase of advertising—the television station could hardly be ignorant of the identity of the advertiser—so the information sharing was not done in a context that suggests that advertising agency shared the information to shift the risk.

Importantly, the facts relevant to this analysis are likely to be undisputed and therefore should not require a trial. Unless the ad agency provides a concrete reason

to believe that it shifted the risk to the television station the controversy can be addressed on a dispositive motion.

## V. INCORPORATING THE GENERAL IN THE PARTICULAR

A significant theme of this article is that courts ought to avoid deciding interpretation cases based on general beliefs about how parties might have bargained (the hypothetical bargain) or based on the basis of preconceived rules, like the plain meaning rule, that make it difficult for a court to examine the bargaining relationship of the parties in the particular case they address. Courts ought to analyze specific bargaining relationships on their own terms, using general beliefs about how parties use terms or negotiate as a way of evaluating the particular bargaining relationship they face.

Incorporating the general in the analysis of particular bargains (rather than relying on general beliefs or presumptions to decide cases) avoids making easy cases difficult and allows courts to make difficult cases easier. In this section, we provide several examples of how our methodology avoids the social cost of either textual or open-contextual interpretations.

### A. *Utica Bank: Preventing Easy Cases from Becoming Difficult*

Too often a general rule like the plain meaning rule does not identify the surplus-maximizing interpretation and leads courts to increase the social cost of interpretation, a cost that could easily be avoided if courts paid attention to inexpensive contextual clues. Our methodology shows courts when the literal meaning of the terms of the contract would not be surplus-maximizing. For example, in *Utica Bank*,<sup>94</sup> the defendants were company executives who guaranteed bank loans to their companies if the bank “does make such loans and discounts[.]”<sup>95</sup> The bank then renewed a preexisting loan that it was about to call and later sued the sureties when the company defaulted. The sureties defended on the ground that the defaulted loan was a renewal of an old loan and not the kind of “loan or discount” for which they gave their surety. The defendants argued that the literal meaning of the term “loans and discounts” did not include renewals, so that defendant sureties were not liable for the preexisting debt.

Judge Cardozo refused to be bound by the literal meaning or the terms of the surety agreement; instead looked to context because “the genesis and aim of the

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<sup>94</sup> *Utica City Nat'l Bank v. Gunn*, 154 N.Y.S. 705 (N.Y. App. Div. 1915).

<sup>95</sup> *Id.* at 706.

transaction may guide the court's choice." What is striking about this case is how easy it is to decide the dispute correctly because of basic non-controverted information. A bank examiner had told the bank to call the loan and the surety agreement was given to induce the bank not to do so.<sup>96</sup> Under this circumstance, the language of the agreement is less important than the context of the agreement. The facts themselves seemed not to be in dispute; the case arose only because of the formal language of the contract and the force of the plain meaning rule, which sustained this dispute long after it should have been decided for the bank. Yet because of the facial cover that the plain meaning rule gave to the interpretation, the bank had to go through a trial and two appeals before it could get its money—a clear wasted social cost.

Had the trial court used our methodology, it could have disposed of the case definitively and inexpensively. The defendants claimed that their surety agreement applied only to future loans, a claim that would have been surplus-maximizing if the parties contemplated future loans when they made the agreement. The plaintiff bank claimed that the agreement aimed to forestall the bank from calling the existing loan, which would have been value maximizing if (a) both parties were made better off by that agreement or if (b) the bank was indifferent to the arrangement but the sureties benefited from it. The circumstances in which the surety agreement was negotiated—which was in the context of a bank examiner's direction to call the loan—was not denied by the defendant's (nor could it be) and provided a strong possibility that the sureties were guaranteeing the prior, not a future, loan. The defendant did not try to prove that it gave its guarantee for future loans only and assumed that the plain meaning rule would prevail. As for the likelihood that the bank would make future loans to the company, once that necessary determinant is found to be false or probabilistically unlikely, the court should easily have ruled against the defendants.<sup>97</sup>

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<sup>96</sup> That is why the agreement was not void for lack of consideration.

<sup>97</sup> Other cases in which textualism made easy cases difficult are: *Beanstalk Grp. v. AM Gen. Corp.*, 283 F.3d 856 (7th Cir. 2002) (holding that a contract setting royalty amount for independent agent marketing the Hummer brand name did not require the company making the Hummer automobile to pay the licensing fee when the company was sold to General Motors; although Hummer trademark was transferred, it was not the kind of transfer for which the independent agent should have expected payment); *Lippman v. Sears Roebuck & Co.*, 280 P.2d 775 (Cal. 1955) (holding that a provision for lease payments geared to monthly sales requires the parties to use recent sales to determine the required payment after the store was no longer used for retail, and that the owner would not have renovated building if tenant could so easily avoid paying rental). Efficient contextualism also allows courts to correctly interpret state law that appears to impose a rule that would reduce surplus. *See, e.g.*, *Baldwin Piano, Inc. v. Deutsche Wurlitzer GmbH*, 392 F.3d 881 (7th Cir. 2004) (although Illinois law governing



### B. *Westgate v. Ford Motor Co.: Making Difficult Cases Easier*

Our methodology can also be used to simplify and streamline even difficult cases, a point we illustrate by examining a typical dealer termination case, *Westgate Ford Truck Sales, Inc. v. Ford Motor Co.*<sup>98</sup> Dealer termination cases can be litigious and expensive, and because *Westgate Ford* involved a contractual ambiguity, the court could not invoke the plain meaning rule and avoid some form of fact-finding process. But that does not justify the prolonged set of trials and appeals that the case created.<sup>99</sup> Had the various courts involved in the case used the method we recommend to determine the relevance and weight of the evidence of a surplus-maximizing interpretation, the litigation could have been streamlined.

Plaintiff *Westgate* was an authorized Ford dealer operating under a franchise agreement with Ford.<sup>100</sup> Ford had a Competitive Price Assistance (“CPA”) program that allowed dealers to request special help in pricing when competitive conditions meant that the dealer could not profitably sell at Ford’s published prices.<sup>101</sup> One component of the CPA program was available to all truck dealers; the other component was available only to those dealers “with a demonstrated need to

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a trademark licensing contract provided that an unlimited license is terminable at will, the court held that the rule does not apply to this contract and enforced a provision limiting the right to terminate; otherwise the trademark would not have been marketable).

<sup>98</sup> 971 N.E.2d 967 (Ohio Ct. App. 2012).

<sup>99</sup> This case has become unnecessarily complicated, bouncing back and forth between the trial court and appellate court several times since 2010. In 2010, the trial court judge granted *Westgate*’s motion for summary judgment on liability and defenses, leaving only the question of damages to the jury. *Westgate Ford Truck Sales, Inc. v. Ford Motor Co.*, No. CV-02-483526, 2010 WL 5855325 (Ohio Com. Pl. Dec. 30, 2010). The jury awarded *Westgate* \$1,984,590,150.00. *Westgate Ford Truck Sales, Inc. v. Ford Motor Co.*, No. CV-02-483526, 2011 WL 2306843 (Ohio Com. Pl. June 10, 2011). Ford’s post-trial motions were unsuccessful, and Ford appealed. *Westgate Ford*, 971 N.E.2d at 970. The appellate court agreed with Ford that “the trial court erred in granting summary judgment to *Westgate* on the issue of liability,” remanding the issue to the trial court for a jury to hear. *Id.* at 973–74. While the jury decided that Ford was not liable, the trial court judge (the same judge that granted *Westgate*’s first motion for summary judgment on liability) granted *Westgate*’s motion notwithstanding the verdict. *Westgate Ford Truck Sales, Inc. v. Ford Motor Co.*, No. CV-02-483526, 2014 WL 1082736 (Ohio Com. Pl. Mar. 12, 2014). The case went back to the appellate court, which again reversed the trial judge’s decision and reiterated that ambiguities are matters of fact that must be decided by a jury. *Westgate Ford Truck Sales Inc. v. Ford Motor Co.*, Nos. 101136, 101073, 2014 WL 6983309 (Ohio Ct. App. Dec. 11, 2014).

<sup>100</sup> *Westgate Ford*, 971 N.E.2d at 969.

<sup>101</sup> *Id.*

petition Ford for additional concessions on a case-by-case basis.”<sup>102</sup> The court referred to the second component as “Appeal CPA.”

Although Westgate had once taken advantage of undisclosed discounts under the Appeal CPA program, it argued that the franchise agreement required Ford to disclose Appeal CPA discounts to other dealers, and that the failure to disclose the discounts was a breach of contract.<sup>103</sup> The breach alleged was built on a supposed obligation of Ford, as written in the parties’ Standard Franchise Agreement (“SFA”), to sell at prices published to all dealers.<sup>104</sup> The contested part of the SFA read:

Sales of COMPANY PRODUCTS by the Company to the Dealer hereunder will be made in accordance with the prices, charges, discounts and other terms of sale set forth in price schedules or other notices published by the Company to the Dealer from time to time in accordance with the applicable TRUCK TERMS OF SALE BULLETIN.<sup>105</sup>

Westgate argued that this provision “required Ford to publish to all of its dealers the Appeal CPA discounts that it was providing to individual dealers, and that Ford’s failure to publish these prices to all dealers constituted a breach of contract.”<sup>106</sup> The lower court agreed and granted Westgate’s Motion for Summary Judgment on Liability.<sup>107</sup> On appeal, Ford argued that, because the SFA defined “Dealer” as Westgate, there was a distinction between the obligation to publish prices to all truck dealers and the obligation to sell trucks to Westgate Ford “in accordance with the prices, charges, discounts, and other terms of sale . . . published by [Ford] to [Westgate].”<sup>108</sup> Given the two competing interpretations, the appellate court remanded the case because it was “unclear exactly what Ford was

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<sup>102</sup> *Id.*

<sup>103</sup> *Id.* at 970.

<sup>104</sup> *Id.* at 969.

<sup>105</sup> *Id.* at 971.

<sup>106</sup> *Id.* at 970.

<sup>107</sup> *Westgate Ford Truck Sales, Inc. v. Ford Motor Co.*, No. CV-02-483526, 2011 WL 2306843 (Ohio Com. Pl. June 10, 2011) (“Ford breached the unambiguous terms of the contract, read as a whole, when it failed to publish prices to all dealers.”).

<sup>108</sup> *Westgate Ford*, 971 N.E.2d at 971.

required to publish to any particular dealer.”<sup>109</sup> The trial court granted Westgate’s motion for summary judgment on liability, which left only the question of damages;<sup>110</sup> the jury awarded Westgate \$1,984,590,150.00.<sup>111</sup> This ruling was reversed on appeal because the jury was given inadequate instructions of the relevant legal standard.<sup>112</sup>

This case would have been streamlined if the court had asked the parties to submit briefs telling the court why the claimed interpretation would be surplus-maximizing. Instead, the litigation spilled over into matters that were not central to the economics of the dispute and the litigation became costly and complex. Here is how the court should have determined the surplus maximizing interpretation.

Westgate’s interpretation would be surplus-maximizing if transparency (publishing the Appeal CPA discounts to other Ford dealers) would protect Ford dealers from intrabrand competition by disabling Ford from granting the discounts to allow one Ford dealer to take sales away from another Ford dealer. The value of each dealership would go up if each dealer was protected against intrabrand competition, without hurting Ford. In other words, Westgate’s interpretation requiring transparency in the publication of the Appeal CPA would be surplus-maximizing if it allowed Westgate and other dealers to monitor the discounts Ford gave to ensure that Ford did not discriminate between dealers concerning the effective price they paid when they competed against each other. To prevail Westgate would have to prove that the value of its dealership went down because it lost sales to other Ford dealers on account of Ford’s secret discounts to other Ford dealers.

On the other hand, Ford’s interpretation of its two-tier pricing system would be surplus-maximizing if it allowed Ford to enable a dealer to sell to customers that might have otherwise bought a different brand of truck, and if Ford’s incentive to grant the Appeal CPA discounts would have decreased if Ford had to make those discounts known to other Ford dealers. This would increase surplus by making each dealership more valuable without hurting any other Ford dealer or Ford itself. The increase in interbrand competitiveness would benefit Ford and its dealers by increasing sales of Ford trucks.

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<sup>109</sup> *Id.* at 972.

<sup>110</sup> *Westgate Ford*, 2011 WL 2306843.

<sup>111</sup> *Id.*

<sup>112</sup> *Westgate Ford*, 971 N.E.2d at 975.

In other words, the contest was about whether Ford could increase interbrand competitiveness without also increasing intrabrand competitiveness. This would be possible if Ford dealers were separated enough that they did not face intrabrand competition or if Ford refused to give an Appeal CPA to a dealer that would use it to take sales from other Ford dealers. And Ford had a surplus-maximizing reason to counter the argument that publishing the Appeal CPA discounts would improve surplus by assuring dealers that they were given an equal opportunity to get the discounts. Ford would point out that keeping the discounts secret was surplus-maximizing because only Ford could determine whether to give the discount and that Ford would lose its incentive to give the discounts if making the discounts transparent induced the dealers to pressure Ford to increase the discounts. Moreover, Ford's refusal to report the appeal discounts to all Ford dealers would be justified if it kept each Ford dealer from poaching on the efforts that one dealer made to induce a customer not to buy a different brand of truck.

Analyzing the competing interpretations to determine which is most likely to be profit maximizing raised factual disputes, but because our methodology allows courts to identify with precision the facts that are relevant to a surplus-maximizing interpretation, the court can streamline discovery. Depending on what facts the discovery shows it might even be possible to rule on the merits without a trial. After all, if Ford could show that intrabrand competition was not possible in Westgate's market, there would be no determinant fact at issue, and if Westgate could show sufficient evidence that Ford used the Appeal CPA discounts to allow Ford dealers to take business away from each other, Westgate's interpretation would be surplus-maximizing. Finally, one other aspect of this case might have simplified the factual issues even further. For a time, Westgate took advantage of the Appeal CPA discounts without complaining that they discounts were never published, and the court could well have accepted this as an admission that the non-published Appeal CPA discounts were profit maximizing unless Westgate could explain why its attitude toward the non-published Appeal CPA discounts changed. In any event, the courts need not have imposed the social costs they did.

### C. Columbia Nitrogen: *Checking Economic Assumptions*

Deciding cases on the basis of particular bargaining relationships rather than general beliefs about contracting tendencies will avoid mistakes in even difficult cases. Take, for example, *Columbia Nitrogen Corp. v. Royster Co.*,<sup>113</sup> a case that has become the poster child for economic (and other) criticism of judicial

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<sup>113</sup> 451 F.2d 3 (4th Cir. 1971).

intervention.<sup>114</sup> At first reading, the contract there appeared to require the buyer to buy a minimum tonnage of phosphate from the seller at a stated price (subject to an “escalation factor up or down” for changes in raw material and labor costs).<sup>115</sup> When the market price “plunged precipitously”<sup>116</sup> the buyer substantially reduced its purchases. Rather than enforcing the contract as if it contained a minimum purchase requirement, the court of appeals overruled the district court and held that extrinsic evidence was admissible, thus allowing the jury to interpret the contract in the light of proffered testimony about the context of the negotiations.<sup>117</sup>

To many, the court appeared to be relieving the buyer of a minimum purchase obligation that the buyer had freely accepted. If the contract did provide, as it seemed to, and as economists have assumed, that the buyer had an obligation to purchase a minimum quantity of phosphate, the economic criticism of the outcome is justified.<sup>118</sup> Refusing to enforce the obligation would weaken the contract system by putting courts, rather than parties, in the business of determining obligations in the light of changed circumstances. And if the parties chose terms that disregarded their past dealings, they should not be bound by their past dealings.<sup>119</sup>

Why then do we question the standard economic interpretation of the case? First, contrary to popular belief, the contract did not provide, explicitly, that the buyer would purchase the quantities provided in the contract; the contract was more ambiguous than has been conventionally realized. The contract stated that:

Contract made as of this 8th day of May between COLUMBIA NITROGEN CORPORATION, a Delaware corporation, (hereinafter called the Buyer) hereby

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<sup>114</sup> See GOLDBERG, *supra* note 14, at 162; Roger W. Kirst, *Usage of Trade and Course of Dealing: Subversion of the UCC Theory*, 1977 U. ILL. L. FORUM 811, 844–45 (1977); Richard W. Duesenberg, *General Provisions, Sales, Bulk Transfers, and Documents of Title*, 28 BUS. LAW. 805, 824 (1973) (proclaiming that the result “boggles the reasonable mind”).

<sup>115</sup> *Columbia Nitrogen*, 451 F.2d at 6 n.2.

<sup>116</sup> *Columbia Nitrogen*, 451 F.2d at 7.

<sup>117</sup> *Id.* at 9.

<sup>118</sup> We are therefore not challenging Victor Goldberg’s evaluation of the case if the contract was, as he assumed, a minimum purchase agreement. GOLDBERG, *supra* note 14, at 179. We are challenging his assumption that the contract was, in fact, a minimum purchase agreement. As we discuss in the text, it seems unlikely that Columbia Nitrogen in fact agreed to purchase the quantities specified in the contract.

<sup>119</sup> Unlike *Hurst* (discussed in the text accompanying notes 87–91), trade usage was not introduced as evidence of the meaning the parties must have attributed to a term they used. Instead, the evidence was produced to show that the buyer never agreed to purchase a minimum amount.

agrees to purchase and accept from F.S. ROYSTER GUANO COMPANY, a Virginia corporation, (hereinafter called the Seller) agrees to furnish quantities of Diammonium Phosphate 18-46-0, Granular Triple Superphosphate 0-46-0, and Run-of-Pile Triple Superphosphate 0-46-0 on the following terms and conditions.<sup>120</sup>

Directly below that language the contract shows the “minimum tonnage per year” of various grades of phosphate. Because this general language could characterize a minimum purchase agreement, the parties might well have meant that the buyer would purchase the stipulated quantities of phosphate. If that is what the parties meant, then both contract law and the economic interpretation of contracts suggest that the buyer should not be excused from its purchase obligation except for unforeseen circumstances that would amount to a legal excuse for nonperformance.

Yet the context of this case shows the danger of relying on a textual interpretation. The language is not what it seems. Right after the description of “minimum tonnage per year” the contract provided: “Seller agrees to provide additional quantities beyond the minimum specified tonnage for products listed above provided Seller has the capacity and ability to provide such additional quantities.”<sup>121</sup> This makes the meaning of the “minimum tonnage per year” ambiguous because it seems to relate the “minimum tonnage” to the seller’s obligations rather than to the buyer’s obligations.<sup>122</sup> Taking the two sentences together, the language suggests that the contract obligated the seller to supply the minimum tonnage and to provide additional tonnage if it had the capacity to do so. Under this reading, the seller was guaranteeing a minimum tonnage per year, but the buyer was not agreeing to buy a minimum tonnage per year. So the interpretive question is whether the contract was, in reality, a minimum supply agreement or a minimum purchase agreement, or both.

Given this ambiguity, one cannot approach *Columbia Nitrogen* assuming that the buyer was required to purchase a minimum quantity of phosphate, for that would assume away the interpretive issue in the case. If the buyer was not required to purchase a minimum quantity of phosphate, it would not have breached the

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<sup>120</sup> *Columbia Nitrogen*, 451 F.2d at 6 & nn.2, 7.

<sup>121</sup> *Id.* at 7 n.2.

<sup>122</sup> The Fourth Circuit itself noted that the contract refers to products supplied under the contract, not to products (alone) or even products purchased under the contract. *Id.* at 10. The language used is consistent with the idea that this is a minimum supply agreement.

contract when it decreased its purchases of phosphate. Moreover, the use of contextual evidence to decide what obligations the buyer had undertaken would be perfectly legitimate because it would avoid a mistaken textual interpretation of the contract.<sup>123</sup>

Consider a factor that has been underemphasized in the literature. Although minimum purchase agreements are normal, they generally occur when the buyer is able to predict its requirements of the product (so that it can manage its risk of over-purchasing), but here the buyer was not buying for its own account but for resale. The buyer, a seller of raw materials, did not make any product that used phosphate; instead, it planned on reselling it, using its contacts in the industry and its brokerage subsidiary to make a market for Royster's phosphate production. It had no assured market and a minimum purchase agreement would have put it at a substantial risk,<sup>124</sup> especially because it had a minimum purchase agreement with a different phosphate supplier. The seller knew these facts. Although it is possible that a company would sign a minimum purchase agreement even though it did not use phosphate in manufacturing and could not easily predict its phosphate requirements, the probability of that happening is not great unless it received a substantial discount or had inexpensive warehousing capability.<sup>125</sup> Although Columbia Nitrogen's arguments tended to be formal (extrinsic evidence should be allowed) rather than evidentiary (this was not a minimum purchase agreement), its

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<sup>123</sup> The court did not find the ambiguity in the contract that we do; it denied that an ambiguity was necessary before invoking trade usage or course of dealing. Accordingly, the court did not ask, as we do, whether this was really a minimum purchase agreement; the court gave credence to usages of trade to vary what it assumed were the terms of the contract—an approach with which we disagree.

<sup>124</sup> Joint Appendix on Appeal at 105 (Transcript of Oral Arguments in District Court, *Columbia Nitrogen Corp. v. Royster Co.*, 451 F.2d 3 (4th Cir. 1971) [hereinafter Joint Appendix]).

<sup>125</sup> Although the price specified in the contract was lower than the price specified in the buyer's contract with another supplier, it is not clear that it was lower by a significant amount. Joint Appendix, *supra* note 124, at 287. The Fourth Circuit pointed to other evidence that this was not a minimum purchase contract. Ordinarily, one would expect a minimum purchase agreement to protect the buyer from price decreases, but this contract "neither permits nor prohibits" the parties from "adjusting prices and quantities to reflect a declining market." *Columbia Nitrogen*, 451 F.2d at 9–10. The seller refused to give the buyer a price protection clause that would be common in a minimum purchase agreement; this is further evidence that the parties did not consider this to be a minimum purchase agreement. Joint Appendix, *supra* note 124, at 302. In addition, other terms that one would expect in a minimum purchase agreement were missing. *Columbia Nitrogen*, 451 F.2d at 10.

evidence included facts that would support the claim that it did not promise to buy a minimum quantity.<sup>126</sup>

Not only would the buyer have had no reason to sign a minimum purchase agreement, the seller had a reason for signing a minimum supply agreement and for making it look like a minimum purchase agreement. In this case, a minimum sales agreement made sense for the seller because, as the buyer certainly knew, the seller had excess capacity and encountered little risk in guaranteeing to make a minimum quantity available to the buyer.<sup>127</sup> Moreover, the seller was using this agreement to secure financing for the phosphate plant that it was building, so it had an interest in making its banks believe that it had addressed the risk of constructing excess capacity.<sup>128</sup>

Even beyond these basic (and undisputed) contextual facts, the relationship between buyer and supplier was unlike the relationship in the usual minimum purchase contract. The buyer and seller had a working relationship over a number of years, but their normal roles were reversed in the contract under consideration. The buyer under this contract was the seller in their prior dealings and the seller under this contract was the buyer in their prior dealings. The buyer, Columbia Nitrogen, sold raw materials for fertilizer and the seller in this case, Royster, made fertilizer and sold it to farmers. Royster, the seller in this contract, decided to make, rather than buy the phosphate it needed in the fertilizer business and built in excess capacity to reach an efficient scale; this reduced the cost of the phosphate it used in its business, but only if it achieved the efficient scale of production by selling outside the fertilizer market. Because its expertise was in the fertilizer market not the raw materials market, Royster was happy to sell the excess phosphate to Columbia Nitrogen, which had expertise and markets for selling raw materials. The

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<sup>126</sup> In fact, Columbia Nitrogen argued that this was not a minimum quantity agreement (which it termed a take-or-pay agreement). As Victor Goldberg relates it, Columbia Nitrogen argued that its obligation was only to use its best efforts to sell the quantity in the contract and that Royster appreciated the difference between purchasers for resale, like Columbia Nitrogen, and purchasers for use. GOLDBERG, *supra* note 14, at 168. In fact, a penalty clause was eliminated from the draft of the contract, which Columbia Nitrogen argued took away the implication that this was a take-or-pay contract for a minimum amount. Joint Appendix, *supra* note 124, at 132, 134 & 300. For Columbia Nitrogen, any implication of a minimum purchase requirement was offset by the implicit price protection that came from prior dealings between the parties, for Columbia's testimony showed that when selling to Royster Columbia, it had always adjusted the contract price to the market price. Joint Appendix, *supra* note 124, at 136–37.

<sup>127</sup> Joint Appendix, *supra* note 124, at 100, 246.

<sup>128</sup> Columbia Nitrogen apparently learned this after the contract was signed. See GOLDBERG, *supra* note 14, at 170.



deal made sense for Columbia because Columbia had recently purchased a broker that, by matching suppliers and buyers, made markets in these raw materials. But Royster continued to be a major buyer from Columbia in other markets.<sup>129</sup>

In light of this background, was the specification of a minimum tonnage per year an obligation of the buyer or of the seller? Columbia Nitrogen, the buyer, offered proof that the amount of purchases could be adjusted to reflect market conditions, which were highly unstable in the fertilizer business.<sup>130</sup> And because Columbia was asserting no fixed purchase obligation, it was asserting that Royster would renegotiate the price if market prices fell. Under this interpretation, the term “minimum tonnage per year” was the amount that Royster had to be willing to supply. Royster, the seller, asserted that the term “minimum tonnage per year” required Columbia to purchase at least that much each year. How might a court systematically try to determine the surplus-producing obligations of the parties?

If Royster’s interpretation prevailed, Columbia Nitrogen would have to pay for that amount of phosphate each year at the contract price (as adjusted, pursuant to the contract, for raw material cost changes). If Columbia’s interpretation prevailed, the amount of Columbia’s purchases would be unspecified in the contract and Columbia would not have to purchase any particular amount of phosphate at the price called for by the contract, but would be required to exercise its option to purchase in good faith. The contract is allocating one of two risks. If the contract requires Columbia to buy a minimum quantity, Columbia bears the risk that it will not be able to use that quantity productively. If the contract instead provides that Royster must set aside a minimum quantity each year for Columbia, Royster will assume the risk that demand for phosphate will go up and that it would be locked into selling to Columbia Nitrogen when, in fact, it would be better off selling to others.

Royster’s interpretation would be surplus-maximizing if Columbia had agreed to assume the risk that it would be required to buy more phosphate than it needed. It would be plausible to believe that assertion if either (a) Columbia received a

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<sup>129</sup> The fact that the seller, Royster, was also a major buyer from Columbia gave rise to an unsuccessful claim that Royster’s purchases were used as leverage to induce Columbia to enter into this contract. Columbia also alleged that it was just that leverage that reduced Royster’s incentive to negotiate a fair settlement when market conditions changed. Joint Appendix, *supra* note 124, at 8, 249.

<sup>130</sup> According to the testimony, the practice of adjusting the terms of the contract was not only common within the industry but was justified by the frequency and severity of price changes between the time of contracting and the time of performance. Joint Appendix, *supra* note 124, at 102–03, 125–27, 132–37, 286–89.

price sufficiently below the market price to compensate them for that risk or if (b) Columbia were in a position to minimize that risk by accurately estimating its needs or selling unneeded phosphate on the market. Proposition (a) would be plausible if we could compare the price in the contract with the market price at the time of contracting and if the “escalator clause” allowed the price to stay below market price when prices went down. We have inadequate information about the relationship between the contract price and the market price and about how the “escalator clause” would function.

Proposition (b) would be true if (i) Columbia made products with the phosphate and could reasonably predict its needs for phosphate by reasonably predicting its sales of products manufactured with phosphate or if (ii) Columbia sold in diverse markets that did not move together, so that if Columbia’s phosphate sales went down in one market Columbia could sell the phosphate in other markets.

Columbia’s interpretation would be plausible if: (a) Royster built excess capacity to lower its cost of acquiring phosphate; (b) Royster were not in the business of selling phosphate and faced barriers to getting into that business; and (c) Royster was viewing Columbia as its sales agent or broker. Assertion (a) seems to have been true and admitted by Royster. Assertion (b) would be true if (i) Royster did not have relationships with purchasers of phosphate, and (ii) could not easily build those relationships from the relationships it had. Assertion (c) would be true if (i) Columbia had contacts as a supplier of phosphate to non-fertilizer users that Royster did not have and if (ii) buying Columbia’s expertise in non-fertilizer markets would make sense economically, and if (iii) Royster had a reason—a part of its private projects—to make it look as if Columbia has agreed to buy a minimum amount when Columbia did not agree to that.

In summary, the interpretive issue is whether it is likely that Royster was hiring Columbia to function as a company that would find markets for its excess phosphate (in which case the term “minimum tonnage per year” would signify the minimum amount that it guaranteed Columbia) or whether it was selling a fixed amount to Columbia. Although we cannot say anything conclusive about this matter without considering the evidence in greater detail, the methodology we suggests allows courts to focus on the evidence that is most important to the controversy and to use probabilistic determinations to limit the cost of making the necessary empirical determinations.

## VI. CONCLUSION

A significant question in legal methodology is how a court can move between general propositions of law or presumptions about human behavior and the facts of a particular controversy. We believe that contract interpretation has been fraught with danger because interpretive methodologies start with generalizations and seek

to impose those generalizations on the facts of particular interpretive controversies. Presumptions about the meaning of particular terms, about whether parties intend the contract to be fully integrated, and about the parties' preferred interpretive methodology all ask courts to decide controversies on the basis of generalizations that may ignore the bargaining position of the parties in a particular controversy.

In our view, interpretation must be case-specific because it is unproductive (and impossible) to try to specify in advance the weight to be given the literal meaning of the terms of the agreement or various kinds of contextual facts that might be relevant to the interpretation. Because the economic function of exchange is to allow the parties to tailor their obligations to the specific circumstances that will allow each party to achieve her private projects, interpretation ought to recognize the personal, particular, and idiosyncratic nature of contracting. We do not believe that an approach based on generalizations about the relative importance of text or context in contracting can do anything but mislead courts into making easy cases difficult and difficult cases unmanageable. The problem, as we see it, is that generalizations about contracting practices are likely to be wrong often enough to make them counterproductive. Although some sophisticated business parties will write contracts that minimize uncertainty, even those contracts will not be able to fully anticipate (and address) all possible future states of the world.

Economic analysis supports the interpretive task because the subject matter of a contract embodies an exchange in which each party's obligations represent the price that each party must pay to achieve its private projects. The determination of that price (the obligations under the contract) is an inherently economic determination; textualism is not. Moreover, economists helpfully emphasize the importance of conserving on the cost of interpretation to the extent that cost savings are consistent with an interpretation that accurately defines the parties' surplus-maximizing obligations. Judges understand the basic economic task: to minimize the cost of enforcement in a way that is consistent with the accurate determination of the parties' obligations (that is, to minimize enforcement and error costs).

Our approach, however, differs from competing economic visions in several important respects. First, we think that it is impossible and unproductive to determine beforehand what weight a court ought to give to the text of the contract or to various contextual factors. The debate about the relative merits of textualist and contextualist methods appears to us to be based on a false assumption—namely, the assumption that a court ought to choose a method of interpretation before it does the interpretation. In our approach, the court asks a straightforward interpretive question: which of the interpretations offered by the parties is likely to be surplus-maximizing given the nature of the *ex ante* relationship, the contractual terms that are not in dispute, and the facts that are necessary determinants of the

surplus-maximizing interpretation. Our method therefore bypasses the judicial step of choosing between textualist and contextualist methodologies before the judges undertake the interpretation (or, if a court feels constrained to use either a textual or a contextual approach, offers an economic method for applying the chosen approach). Instead, the weight given to the text and to various kinds of contextual facts are determined by analyzing the parties' surplus-maximizing claims to determine what empirical claims are necessary for those surplus-maximizing interpretations to be true.

Second, our approach puts the contracting parties' relationship at the center of the analysis, making each party's private goals and what it legitimately expected from its counterparty the fulcrum of the study. This recognizes that, contrary to conventional beliefs, interpretation cannot seek to determine the intent of the parties. When a term's meaning is in dispute, either the parties had no joint intent or one of the parties is arguing opportunistically. The court's goal must be to determine what obligations each of the parties should have understood or accepted given the nature of their relationship and the terms that are not in dispute, including the obligation to identify possible interpretive misunderstandings. Moreover, because negotiating parties must choose between multiple equilibria, only their relationship and the terms not in dispute allow us to determine what choices each party made that are relevant to interpretation. Finally, because the parties may seek to minimize costs along several dimensions (negotiating costs, post-contractual negotiating costs, and enforcement costs) and because those dimensions interact on each other in non-linear ways, only by examining the relationship can a court determine how the parties sought to minimize the relevant costs and which party ought to have done more to minimize costs.

Third, our model does not view the litigation process fearfully. It asserts that courts that employ our structured methodology will be able to manage the cost of enforcement by determining whether the empirical claims that are necessary determinants of an interpretation are uncontested and how they can be efficiently addressed when contested. Under efficient contextualism, courts will be able to make a case-by-case determination of whether a trial is needed and how the trial can be streamlined to save costs. Inquiries into matters such as usage of trade and course of dealing will focus only on the information from such practices that is relevant to the interpretation, and will not get bogged down in empirical debates about trade usage and course of dealing as ends in their own right.

The methodology we recommend will enhance the institution of contracting in several ways. By isolating the empirical claims that are necessary to make an interpretation surplus-maximizing, courts can reduce the cost of enforcement, avoiding trials or focusing trials on disputed empirical claims that cannot be decided on the basis of probabilities. This will reduce the social costs of interpretation and the errant interpretations that textualist courts sometimes stumble

into. In addition, as judges become accustomed to analyzing bargaining relationships in the context of the terms of exchange that are not disputed, they will begin to see patterns develop in the cases that further reduce the cost of enforcement because they will allow judges to recognize cases that have similar relational dynamics and treat them accordingly. Disputes over termination clauses and the responsibility of agents, for example, will begin to fall into patterns that are easily recognized and decided on the basis of standard criteria of surplus maximization. Our methodology also reduces the costs of contracting by allowing the parties to trust judicial interpretation to be efficient and surplus-maximizing, reducing the need to postpone performance and invest in further negotiation to prevent opportunistic bargainers or performers. Finally, our method will, at the margins, increase the accuracy of interpretation by allowing courts to focus on the indicia of a surplus-maximizing contract and to discipline their intuition with structured economic analysis.