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INTRODUCTION

The distinguished scholars who gathered last year to honor Ian Macneil and to reflect on his contributions to the understanding of contract and contract law represent diverse methodologies and approach the vexing problems raised by relational contracts from different normative perspectives. But on one point, I daresay, we all agree: The central task in developing a plausible normative theory of contract law is to specify the appropriate role of the state in regulating incomplete or relational contracts. Complete contracts (to the extent that they exist in the real world) are rarely, if ever, breached since by definition the pay-offs for every relevant action and the corresponding sanctions for non performance are prescribed in the contract. In the case of incomplete (or relational) contracts, however, parties have incentives to breach by exploiting gaps in the contract. Making the verifiable terms of the contract legally enforceable and regulating incompleteness in a consistent manner reduces, but does not eliminate, these incentives to breach. There still remains the fundamental question: Should the law seek to complete the contract for the parties? And, if so, from what vantage point should the contractual gaps be filled? Determining the answers to these questions has preoccupied contract law scholars for the past fifteen years.

P1 [1] Dean and Lewis F. Powell, Jr. Professor of Law, University of Virginia

In the essay that follows, I review the academic debate and outline the core arguments for (and difficulties with) three alternative strategies for interpreting relational contracts. Thereafter, I evaluate each strategy in terms of the lessons that are available to us from theory and experience. In particular, I examine the insights from the recent theoretical literature on the economics of incomplete contracting and test those insights against the results of an analysis of the cases interpreting disputed contracts under the significantly different regimes of the Uniform Commercial Code and the common law over the past thirty years.

As the title of the paper implies, the case for formalism in interpreting relational contracts emerges out of this analysis. The contract theory literature suggests that the activist role courts traditionally have been asked to assume in specifying default rules ex ante and/or adjusting contractual risks ex post may be far less useful in a complex, heterogeneous economy. Moreover, the invitation to courts to create broadly useful default rules or to undertake equitable adjustment of apparently harsh contract terms threatens a parallel goal of predictable, transparent interpretation of explicit contract terms. If, as theory suggests, the state is simply incapable of supplying parties in a complex economy with useful defaults ex ante or imposing fair outcomes ex post, the better instrumental strategy is for courts to accept the limits imposed by legal formalism and interpret the facially unambiguous terms of disputed contracts literalistically. Not only would a rigorous application of the common law plain meaning and parol evidence rules preserve the value of predictable interpretation, but the analysis suggests as well that common

law formalism has an heretofore unrecognized role in expanding the menu of legally blessed standard form terms and clauses that further reduce contracting costs for most parties.

At bottom, the merits of these theoretical speculations turn on the empirical realities. While much of the available evidence is anecdotal, it does point unambiguously to a contrast between the functionalist interpretation of the Uniform Commercial Code and the formalist interpretation that is retained by many common law courts and by the private arbitral regimes of trade associations and other intermediaries. The formalist approach seems to have created a more hospitable environment; one that appears to support both reliable interpretation of contract language and the evolutionary production of standardized and appropriately tailored contract terms. Evidence that commercial parties, whose contracts nominally fall under the jurisdiction of the Code, opt instead for private regimes that employ formalist modes of interpretation further challenges the unquestioned assumption of most contemporary scholars that functionalism is a priori superior to formalism. While the case for formalism is a tentative one, the evidence is sufficient to shift the intellectual burden of proof to those who would defend the activist strategies unleashed by the Uniform Commercial Code.

I. OPTIMAL STRATEGIES FOR INTERPRETING RELATIONAL CONTRACTS

The Academic Debate

The academic debate begins with a factual claim about which all contract law theorists would agree. If the state chooses to legally enforce disputed contracts, courts and other decision makers will be asked to interpret the signals that the contracting parties have used, however imperfectly, as their instruments for allocating contractual risk. These signals include what the parties wrote (and did not write) and said (and did not say), as well as the context in which these signals were exchanged.[2] But this interpretive task is not self-executing. It requires a court (or other decision maker) to select among (at least) three discrete interpretive strategies. The choice among these strategies will determine the mode of interpretation that is chosen and, consequently, the shape and content of contract law. Given the stakes, it is not surprising that the academic debate over which strategy is best has been fierce and contentious.

One strategy is for the state to seek to achieve *ex ante efficiency.* This strategy is designed to protect (and even improve) the utility of the set of contractual signals for future parties. It requires courts to ignore the litigating parties subjective intentions and fill contractual gaps

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P1 [2] The state's general rules of contract provide a set of standard gap-filling assumptions or default terms. But every contract requires the parties to provide some additional individualized content. These combinations of express terms and default terms operate on two distinct levels. On one level, they serve as an attempted interparty communication of the risks and entitlements being exchanged. On another level, express terms and default terms communicate evidence of the contractual understanding to the state. Thus, they also signal the legal relationship between the parties. Unfortunately, these signals are inherently error prone. Much of the risk of error derives from the inherent tensions between the verifiable express terms that the parties supply and the state supplied default terms. See generally, Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms, 73* Cal. L. Rev. 261 (1985).

objectively--that is, according to assumptions about the risks that parties similarly situated would plausibly have agreed to bear at the time the contract was made. This is the default rule paradigm that has occupied much of the agenda of the law and economics branch of relational theory.[3]

The argument in favor of the default rule strategy runs along the following lines. In a world where Coasian assumptions of zero transactions costs hold, the choice among gap-filling default rules is irrelevant because parties can and will negotiate around suboptimal legal rules. But in a world of transactions costs anything can happen, and, absent substantial data on these costs, one cannot predict that any given rule is better than any other for any particular set of contracting parties. Surely, though, some rule for allocating common contracting risks is preferable to no rule. If so, the law ought to adopt the rule that the broadest number of parties would adopt were transactions costs low enough for negotiators to tailor-make their own rules. A legal rule mirroring what most parties would adopt where transactions costs are low saves those parties the time, cost and error inherent in negotiating contract terms and reducing them to writing. Where transactions costs are too high for parties to fashion their own rule, it nonetheless

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P1 [3] For a representative sample of the default rule literature, see Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation,* 69 Va. L. Rev. 967 (1983); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules,* 99 Yale L. J. 87 (1989); Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules,* 101 Yale L. J. 729 (1992); Lucian A. Bebchuk & Steven Shavell, *Information and the Scope of Liability for Breach of Contract: The Rule of Hadley v. Baxendale,* 7 J. L. Econ. & Org. 284 (1991); Jules L. Coleman et al., *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law, 12* Harv. J. L.& Pub. Pol. 639 (1989); Richard Craswell, *Contract Law, Default Rules and the Philosophy of Promising* , 88 Mich. L. Rev. 489 (1989); Jason Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules,* 100 Yale L. J. 615 (1990); Alan Schwartz, *A Theory of Loan Priorities,* 18 J. Legal. Stud. 209 (1989); Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts,* 19 J. Legal Stud. 597 (1990); Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law,* 3 S. Cal. Interdisciplinary L. J. 389 (1994).

is normatively correct to provide them with the rule that they probably would have chosen for themselves at the time of contracting had they been able to bargain. Atypical parties, after all, are not disadvantaged by the specification of a "majoritarian" default rule, as they remain free to opt out of the default and design their own tailor-made alternative.[4]

There is a second strategy. Rather than attempt to specify default rules that fill the gaps ex ante, the courts can seek to direct the *ex post efficient* result. That is, they can fill in the "right" result or the "right relational" result by imposing an equitable adjustment that takes all of the relational and contextual factors into account as they appear at the time of adjudication. This has been the solution most frequently suggested by the law and society branch of relational contract scholars.[5] Here the argument proceeds from the claim that relational contracts create reciprocal "relational" duties. Courts should enforce these duties when the parties cannot agree.[6] For example, in relational contexts, changed circumstances that materialize after the contract was made will sometimes threaten to impose severe losses on a disadvantaged party. The severity of

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P1 4 See Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. Legal Stud. 597, 606-613 (1990). This preference for "majoritarian" default rules does not undermine the selection of default rules designed to stimulate further negotiation. Certain default rules are set, not because they represent the ultimate allocation preferred by most bargainers, but rather because they are best suited to inducing one party to share information with the other. See generally, Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L. J. 87 *(1989);* Jason Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules,* 100 Yale L. J. 615 (1990).

P1 5 See generally, Ian Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law, 72* Nw. U. L. Rev. 854 (1978); Ian Macneil, *The Many Futures of Contract,* 47 S.Cal. L. Rev. 691 (1974); Stuart Macaulay, *Non-Contractual Relations in Business,* 28 Am. Soc. Rev. 555 (1963).

P1 6 Robert Hillman, *Court Adjustment of Long-Term Contracts: An Analysis Under Modern Contract Law,* 1987 Duke L. J. 1.

the available contractual remedies–whether specific performance or damages-- implies that the disadvantaged party did not fully consent to the losses that enforcement would cause. In this situation, Richard Speidel has argued that a court-imposed solution would do "little damage to the requirement of consent in contract law."[7] There is simply a "gap in the agreement or risk allocation" that a court can fill based upon information available to it at the time of adjudication.[8] In sum, courts should fill such gaps by creating contract terms that are fair ex post.

There is a third strategy–one suggested by the paper Eric Posner has contributed to this symposium.[9] This third strategy borrows from the physician's classic injunction, "first, do no harm" and resolutely declines to fill any gaps at all. Under this *formalist* approach, courts are instructed not to create ex ante defaults or undertake any ex post adjustments, but to enforce the express terms of the contract literalistically or "as written."[10] To be sure, a formalist strategy

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P1 7 Richard E. Speidel, *Court Imposed Price Adjustments Under Long-Term Supply Contracts,* 76 Nw. U. L. Rev. 369 (1981).

P1 8 Richard E. Speidel, *The New Spirit of Contract, 2* J. Law & Commerce 193 (1983).

P1 9 Eric Posner, *Relational Contracts and Incompetent Courts*,-- Nw. U. L. Rev.-- (2000). Posner poses a mind experiment in which he assumes that courts are "radically incompetent" and asks what legal arrangements can be justified in those circumstances. The formalist strategy discussed in text does not assume radical incompetence, but only that courts are poorly equipped to pursue either of the two previous strategies.

P1 10 Formalism in contract interpretation is not new, of course. But the "new formalism" rejects the categorical imperative to deduce rules from first principles that characterized classical formalism as practiced by the late 19th century Langdellians. See Thomas Grey, *Langdell's Orthodoxy* (199-). The new formalism is pragmatic at its core, emphasizing the *instrumental* value of formalist modes of analysis. Thomas Grey identifies three elements that offer a useful taxonomy of the new formalist approach to interpretation: *objectivism* (a general preference for rules over standards), *common law conceptualism* (a preference for treating common law categories like contract as coherent structures of concepts and principles), and *statutory textualism* (a preference for text-based over purposive interpretation. See Thomas Grey, *The New Formalism* 27-30 (unpublished paper on file). This pragmatic, formalist approach to interpretation in contract law was first suggested in the legal literature by Alan Schwartz. See Alan Schwartz, *Incomplete Contracts,* The New Palgrave Dictionary of Economics and Law (1997).

does not absolutely preclude courts from functional interpretation of a given contract, but it does require the parties expressly to signal ex ante their preference for more aggressive modes of interpretation of the contract terms.[11]

The formalist strategy is not as radical as it seems. It emerges from the classic work of Stuart Macauley advancing the claim that powerful informal norms, rather than legal rules, govern commercial contracting behavior.[12] Following in Macauley's path, I suggested in a later article that parties to relational contracts have learned to behave under two sets of rules: a strict set of rules for legal enforcement and a more flexible set of rules for social enforcement.[13] It may be, therefore, that the great lesson for the courts is that any effort to judicialize these social rules

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P1 11 Since formalist interpretation asks that the court respect the literal and explicit terms of the contract, it logically follows that individual parties can (and should be permitted to) opt out by agreeing ex ante to an express term in the contract that instructs courts to look to the contractual context in specific circumstances. Common examples of such terms are the "gross inequities" or "good faith adjustment" provisions commonly observed in long-term supply contracts. See generally, Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 Calif. L. Rev. 2005, 2051-53 (1987). Along the same general lines, the formalist approach would embrace the right of parties to expressly choose to have any subsequent contractual dispute adjudicated by courts using more functional or contextual modes of interpretation generally. Treating the interpretive methodology as a default rule rather than a mandatory or immutable rule is a logical corollary to one of the instrumental justifications for adopting a formalist methodology for interpretation: that most parties prefer inflexible legal rules deployed in concert with flexible social norms, but that reasons may exist for atypical parties to opt for a more aggressive approach to interpretation. See TAN infra. In sum, literalist modes of interpretation are preferable strategies for the state because (and only because) they better reflect majoritarian preferences than the alternative, functional approaches. To be sure, part of the argument for formalist interpretation is the claim that it is a superior mechanism for generating useful standardized terms *over time*. On this basis, making formalist interpretation a mandatory rule would be one way to produce a greater supply of standardized terms and clauses that might not otherwise emerge if modes of interpretation are regarded as a matter of party choice. I analyze these questions more completely in Part III infra.

P1 12 Macauley, supra note ----at—.

P1 13 Robert E. Scott, *A Relational Theory of Default Rules*, supra note--- at 615 . Lisa Bernstein has subsequently developed this argument in much greater detail. See Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U.Pa.L.Rev. 1765 (1996).

will destroy the very informality that makes them so effective in the first instance.[14]

These, then, are the principal strategic choices the state faces when called upon to adjudicate disputed contracts. The particular strategy that is selected will necessarily affect the method of contractual interpretation that courts employ (and vice versa). If the state selects the "wrong" interpretive strategy or performs its regulatory function in an inconsistent manner, the costs of contracting will rise. Thus, the central question for contract law scholars remains: which strategic objective is best?

In evaluating this question, it is critically important to emphasize what the debate is and is not about. The debate that divides the academics who think about these questions is not over the nature of *contract* as an institution. We are all relationalists now. In that sense Macneil and Macauley have swept the field. Contract, we now know, is complex and subjective and synthetic in every sense of those terms. The debate, rather, is over the proper nature of *contract law*. All contracts are relational, complex and subjective. But contract law, whether we like it or not, is none of those things. Contract law is formal, simple and (returning to Macneil's terminology) *classical.*

Consider, for example, the doctrines of perfect tender, mistake, and excuse. Or the sharply defined rules regarding expectation damages, including the classically prescribed

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P1 14 Scott, *A Relational Theory of Default Rules,* supra note --- at 615.

limitations on consequential damages. These rules assign risks on an all-or-nothing, binary basis. Given the outpouring of academic argument that establishes beyond question the complex, multifaceted dimensions of relational contract, the great question of the day is what to make of the equally well-established reluctance of courts to engage in creative adjustment or more tailored gap-filling to better regulate relational contracts. Thus, the core normative question is whether the failure of contract law to mirror the more complex institution of contract is a good thing or a bad thing. Should we enlarge contract law, as Mel Eisenberg would have us do, so as to better accommodate the complexities of contract?[15] Or should we actually seek to narrow the scope of contract law to give it a smaller domain than it occupies under more aggressive strategies of interpretation?

Interpreting Relational Contracts to Achieve Ex Ante Efficiency

Let's begin with the default rule (or law and economics) paradigm. This perspective argues that to regulate relational contracts efficiently, the state must consistently perform two interdependent but conceptually distinct functions. The first is an interpretive function--the task of "correctly" interpreting the contract terms chosen by contracting parties to allocate contract risk. An interpretation is 'correct' when it is transparent to the litigating parties and predictable to other parties.[16] This interpretive task is made difficult in relational contracts by the question

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P1 15 Melvin A. Eisenberg, --------, --Nw.L.Rev.--(2000).

P1 16 Transparency and predictability, in turn, support the so-called "objective theory" of contract interpretation. See Robert E. Scott & Douglas L. Leslie, *Contract Law And Theory* (2ed. 1993) at 21-23. This principle is famously illustrated in Judge Learned Hand's dictum:

> "A contract has, strictly speaking, nothing to do with the personal, or individual, intent of the parties. If it were proved by twenty bishops that either party, when he used the words,

of whether the parties failed to complete the contract deliberately or inadvertently and whether the incompleteness is a product of high transaction costs or asymmetric information or other endogenous factors.

Standardization is the second function that enhances the ex ante efficiency of relational contracts. The state facilitates the contracting process to the extent that courts, in the process of interpretation, create standardized terms that parties can use thereafter in signaling their intentions thereby removing the uncertainties attendant on interpretation.[17] Standardized signals can be developed in two ways. The first is through a process of "gap filling," where courts interpreting relational contracts elect to condition or qualify the express terms of the contract by specifying default rules that complete the contract. Standardization also occurs when courts interpret authoritatively the meaning of widely used express terms or combinations of express terms. In either case, the key to this process is the standardization of the tools parties use to customize their contracts.

> intended something else than the usual meaning which the law imposed upon them, he would still be held..."

Hotchkiss v. National City Bank, 200 F. 287, 293 (S.D.N.Y. 1911), aff'd 201 F.2d 664 (2d Cir. 1912), aff'd 231U.S. 50 (1913).

See also the court's statement in Chernohorsky v. Northern Liquid Gas Co.:

> "The language of a contract must be understood to mean what it clearly expresses. A court may not depart from the plain meaning of a contract where it is free from ambiguity. In construing the terms of a contract, where the terms are plain and unambiguous, it is the duty of the court to construe it as it stands, even though the parties may have placed a different construction on it."

Chernohorsky v. Northern Liquid Gas Co., 268 Wis. 586, 68 N.W. 2d 429 (1955).

P1 17 For discussions of the efficiency value of standardization in contract and commercial law, see Goetz & Scott, *the Limits of Expanded Choice*, supra note—at 286-288; Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (Or "the Economics of Boilerplate")*, 83 Va. L. Rev. 713 (1997).

The Barriers to Ex Ante Efficiency

The traditional assumption made by most scholars that the state can achieve ex ante efficiency by incorporating default rules from the commercial context into incomplete relational contracts is, at best, simplistic and, at worst, seriously misleading. To the extent that the efficiency norm purports to embrace both predictable interpretations of incomplete contracts as well as the standardization of contract terms, it is subject to a fundamental dilemma: The process of incorporating useful defaults often leads to misinterpretation of the express terms of the contract, while seeking predictability in interpretation undercuts the process of standardization.[18] For example, courts often fill gaps by incorporating context evidence to show that apparently determinate terms in a contract are subject to "reasonable variations" or are only "estimates".[19] On the one hand, official "recognition" of these default understandings may assist future parties in better designing their contractual relationship. But, on the other hand, the act of incorporating these defaults as an aid to interpretation of the litigated contract will also have the effect of conditioning the explicit price and quantity terms in the contract, terms that otherwise appeared

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P1 18 Courts typically interpret the meaning of express terms in an agreement by looking to precisely the same commercial and legal context they use to identify and incorporate default terms. Unfortunately, by giving custom and usages of trade interpretive priority over the express terms in the contract, courts may unwittingly misinterpret the meaning of the express terms the parties have used. Thus, if the law treats the words used to opt out of an otherwise applicable custom or usage as themselves highly elastic and context-relative, attempts to escape those default understandings become problematic. See Robert E. Scott & Douglas L. Leslie, *Contract Law and Theory* (2ed. 1993) at 534-35. See also, Goetz & Scott, *The Limits of Expanded Choice, supra note—at 283-286.*

P1 19 See, e.g., Columbia Nitrogen Corp. v. Royster Co., 451 F.2d 3 (4th Cir. 1971) (course of dealing and usage of trade admitted into evidence to show that express price and quantity terms in written contract were only fair estimates); Modine Mfg. Co. v. North E. Indep. School Dist., 503 S.W. 2d 833, 837-38 (Tex. Civ. App. 1973) (trade usage admitted into evidence to show that express terms should be interpreted as permitting reasonable variations).

fixed and determinate on their face. The problem is not made any easier by a single minded adherence to a textualist or plain meaning interpretation of the contract terms. Such a strategy will diminish the supply of useful standard form defaults that otherwise would have received official "recognition" through incorporation.[20]

These and other related problems expose a central question that challenges the simple form of the default rule paradigm: To what extent do express terms and default rules, and standardized and individualized forms of agreement function in antagonistic rather than complementary ways? To better understand these tensions, we must focus for a moment on the benefits (and the costs) of the incorporation process.

The Benefits of Incorporation. The state's incorporation of standardized contract terms as either "majoritarian" or "tailored" defaults reduces many errors that inhere in incomplete contracting.[21] The benefits of incorporation go far beyond a mere savings of additional resource costs. Standardized terms and understandings that are recognized and publicized by the state bring a collective wisdom and experience that parties are unable to generate individually.

P1 20 Jody S. Kraus & Steven D. Walt, *In Defense of The Incorporation Strategy* in The Jurisprudential Foundations of Corporate and Commercial Law, Cambridge University Press (forthcoming 2000).

P1 21 Majoritarian default rules are those that apply to the largest set of heterogeneous contractors. Tailored defaults, by contrast, apply to smaller subsets of homogeneous parties (such as merchants in a particular trade or business). See Robert E. Scott, *The Uniformity Norm in Commercial Law: A Comparative Analysis of Common Law and Code Methodologies,* in The Jurisprudential Foundations of Corporate and Commercial Law, Cambridge University Press, Jody S.. Kraus and Steven D. Walt eds. (forthcoming 2000).

Individual contracting parties are unlikely to carefully test the meaning of the customary understandings that "go without saying" in the particular trade or industry. Testing various combinations of terms for errors of inconsistency or omission by, for example, specifying all usages and course of dealings as well as dickered express terms explicitly in the contract involves both substantial risks and uncompensated resource costs. First, innovators face the risk that novel statements of common understandings will not express their agreement as they intended. Moreover, contracting parties face an additional, irreducible risk that a court subsequently called upon to interpret the contract will not interpret the novel terms in the manner understood by the parties at the time of contract. Finally, the costs of specification are borne disproportionately by the innovating contractors. Private parties who develop successful packages of standard form contractual terms cannot capture much of the benefit that will accrue to subsequent users.

The unique benefits of incorporation thus derive from the process by which default terms mature and are recognized by the state as having consistent meaning. A principal effect of this evolutionary process is the testing of various combinations of terms and common usages for dangerous but latent defects. In the process of interpreting disputed contracts, courts can (at least in theory) incorporate and publicize as appropriate defaults the "mature" usages and understandings. The incorporation process can ideally function as a regulatory scheme designed to promote these public goods thus ameliorating the inherent collective action problem that retards innovation. Over time, customary terms and common understandings are observable in a wide range of transactions, permitting the identification and removal of errors of ambiguity,

inconsistency or incompleteness.[22]

Institutional Bias: The Costs of Incorporation . The benefits from incorporation are purchased at some considerable cost, however. The state incorporates these privately developed prototypes into the stock of useful default rules through the process of filling gaps in incomplete contracts. The evolution of widely useful standardized terms is thus facilitated by theories of interpretation that use context evidence liberally to supplement both the express terms of an agreement and the state-supplied default rules. This objective clashes, however, with the need to interpret correctly the verifiable express terms in incomplete contracts. Are these verifiable terms to be interpreted as trumping the default rules and thus given a plain meaning interpretation "as written"? Or are they seen as merely supplementing the defaults and thus to be contingent on the default terms that courts deploy to complete the gaps in the contract? This choice between interpreting explicit contractual language as either trumping or supplementing the default rules exposes the fundamental tension between the twin goals of reliable interpretation and useful standardization. Assume, for example, that courts focus single-mindedly on incorporation and on increasing the supply of standardized defaults. Such a strategy will necessarily threaten the integrity of the express terms in disputed contracts because the interpreter will be reluctant to give the explicit terms meanings that conflict with the apparent factual and legal context. After all,

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P1 [22] See Goetz & Scott, *The Limits of Expanded Choice*, supra note--at 286-87. This process functions in much the same way as The Food and Drug Administration's regime for testing new drugs. The FDA tests drugs well beyond the level of precautions that an individual would deploy for any particular product. This level of care explicitly recognizes the public benefits of guarding against low probability but high impact events. Similarly, contract terms may contain latent design defects that cannot be avoided by the simple expedient of urging individuals to exercise greater care in the contracting process. But over time these standard terms mature and are validated by accumulated experience. In that sense, they are "safer" than new, untested terms or combinations of terms. Id.

courts typically interpret contract terms by looking to the very same commercial context they use to incorporate the applicable defaults. While evidence from the contractual context may frequently be useful in clarifying meaning, courts intent on incorporating context may also misuse it in deciding that, no matter what the express terms of the contract may seem to say, the apparent meaning is implausible in light of the circumstances of the transaction.[23]

In sum, incorporation carries costs as well as benefits. The process of incorporating standardized default terms, which aims to reduce the costs of contracting, indirectly produces negative effects in a related dimension of the interpretation process. This fact does not, of course, imply that the state's role in facilitating standardized terms is on balance undesirable. It does suggest, however, that the normative claim that courts should strive for ex ante efficiency through incorporation has ignored significant trade offs in the process by which the state regulates relational contracting. Understanding how best to optimize these trade offs requires a better understanding of contacting behavior. What are the causes of incompleteness in contracts and how best can the state assist parties to such relational contracts? But before we can seek fresh answers to these questions, we first need to consider the alternative interpretive strategies.

An Alternative Strategy: Ex Post Efficiency

P1 [23] See e.g., Brunswick Box Co. v. Coutinho, Caro & Co., 617 F.2d 355 (4th Cir. 1980) (course of performance and surrounding context suggest that standard meaning of F.A.S. term might not be applicable); Columbia Nitrogen Corp. v. Royster Co., 451 F.2d 3 (4th Cir. 1971) (course of dealing and usage of trade, if admitted in evidence, demonstrate that express price and quantity terms in written contract were only "fair estimates"); Modine Mfg. Co. North E. Indep. School Dist., 503 S.W. 2d 833, 837-838 (Tex. Civ. App. 1973)(trade usage admissible to show that express term "capacities shall not be less than indicated" should be interpreted as permitting "reasonable variations in cooling capacity").

A plausible alternative goal for the state is for courts not to develop defaults to promote ex ante efficiency but rather for courts to direct the ex post efficient result. Here the argument is quite straightforward. If there are to be trade offs, why not trade off the chimera of ex ante certainty in favor of ex post efficiency (or fairness). Under this view, the law explicitly recognizes that courts adjudicate a contract dispute only after the parties have 1) failed to specify a complete contract ex ante, 2) failed to renegotiate ex post, and 3) bargaining has broken down. Now assume that courts are in possession of information at the time of adjudication that the parties did not possess ex ante, or at the time of renegotiation. Under these conditions, courts can then fill in the gaps ex post and direct an efficient outcome. While relational contractors would not be able ex ante to predict the pay offs if certain contractual risks materialized, they would know that courts, employing their informational advantage ex post, would reach an equitable adjustment that would be efficient viewed from that vantage point. Efficiency (or fairness) of result would thus replace efficiency of prediction. [24]

There are three objections to the argument for ex post efficiency. First, the unfairness of

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P1 [24] For a representative sampling of the literature that argues for ex post adjustment, see, e.g., Stuart Macaulay, *Elegant Models, Empirical Pictures, and the Complexities of Contract*, 11 Law & Society Review 507 (1977); Leon Trakman, *Winner Take Some: Loss Sharing and Commercial Impracticability, 69* Minn. L. Rev. 471 (1985);Robert Hillman, *Court Adjustment of Long-Term Contracts*, 1987 Duke L. J. 1; Richard Speidel, *The New Spirit of Contract*, 2 J. Law & Comm. 193 (1982); Richard Speidel, *Court-Imposed Adjustments Under Long-Term Supply Contracts*, 76 Nw.U. L. Rev. 369 (1981).

The summary in the text does not, of course, do justice to the differences in approach of the various ex post analysts. Thus, for example, the claim by Robert Hillman that courts should enforce the long term "relational duties" that are created by relational contracts could also be understood as directing courts to find and enforce the ex ante "reasonable expectations" of the parties rather than seek to adjust the contract equitably in order to reach a "fair" result ex post. But this interpretation of Hillman's argument seems inconsistent with the notion that enforcement of the contract should not be ordered where it would impose unforeseeable harms on the promisor. If the parties were aware of these relational duties when they signed the contract, then the duties would be part of the contract and the contract would allocate the risk optimally (or else the parties would not have agreed to it). Thus, this version of the argument collapses to the directive that courts should seek to achieve ex ante efficiency. The other way to understand Hillman's relational argument is that these relational duties direct courts simply to implement "fair" outcomes. This collapses Hillman's relational view into the argument for ex post adjustment advanced by Speidel and others.

enforcing the terms of the contract as written apparently stems from the belief that unforeseeable events caused the promisor to incur large losses. Thus, the ex post strategy requires courts to answer the vexing questions of foreseeability and causation in order to decide how much of the loss the disadvantaged party should bear. There is significant evidence that courts have so much difficulty with these questions that they opt for full enforcement in the great majority of cases involving frustration and excuse.[25] The ex post strategy may thus be assuming a level of competency that courts cannot reasonably achieve. In short, reaching "fair" results may simply be too difficult to implement in specific cases. Second, there is the distributional justice problem of deciding what is a "fair' adjustment. Moral philosophy does not appear to provide criteria with which to answer such micro-distributional questions.

Finally, the strategy of ex post adjustment may have bad incentive effects. Assume, for example, that relational duties are actual duties that the parties undertake toward each other, but that since they arise over time they become part of the contract after the agreement is legally formed. Assume further that these duties are only implicit, and thus unenforceable in litigation. Now consider the case where the parties to a long-term contract develop an understanding that the seller need not perform at a loss. If the seller's costs rise, the parties will adjust the price such that the seller will break even, but the seller will lose its anticipated profit. This implicit understanding is a function of the parties' relative bargaining power. The seller would like the entire profit but lacks the power to get it; the buyer would like to enforce the agreed upon

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P1 [25] See Alan Schwartz & Robert E. Scott, *Sales Law and the Contracting Process at* 436-486 (2ed. 1991) (citing cases and secondary sources).

contract price but lacks the power to get that. Assume thereafter that a court in interpreting this disputed contract finds that sellers can get 50% of their profits in this sort of "frustration situation". In such a case, the seller will be breaching the parties' implicit agreement and, absent a moral principle that suggests that 50% is fairer than nothing in this circumstance, the result of the ex post strategy would be unfortunate. The legal decision would have upset the parties agreement and reduced the incentives for similar parties to develop implicit agreements regarding the allocation of contract risks.[26]

A Formalist Strategy of Interpretation

Both of these two familiar strategies-- seeking ex ante efficiency or ex post efficiency-- presuppose a role for courts in filling gaps in incomplete contracts. The principal difference is whether gaps are filled from an ex ante or an ex post perspective. But (as I suggested earlier) there is a third strategy for courts to consider: decline to fill gaps at all. From this formalist perspective, the legal terms in relational contracts would be subject to a literalistic interpretation; courts would enforce verifiable express terms as written and decline the invitation to complete the contract. The benefits of this strategy are obvious. If correct interpretation is indeed an important value and if this requires interpretation that is transparent and predictable, then it follows that restricting the role of legal enforcement to the enforcement of facially unambiguous express terms will (over time) generate better and more accurate interpretations of those portions

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P1 [26] Schwartz & Scott, supra note — at 482-483. For a view that implicit contractual agreements exist and should be encouraged, see Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 Calif. L. Rev. 2005 (1987).

of disputed contracts that the parties choose to reduce to formal, legal terms.[27]

The costs of the formalist strategy are equally obvious. A return to a formalist conception of contract law (even one that is grounded in an instrumental pragmatism) will increase the number of disputed contracts in which enforcement is denied because the contract is found to be fatally incomplete and/ or ambiguous. Moreover, contracting parties now will be required to incur the costs of developing standard form prototypes for expressly allocating common risks that contract law might otherwise have assigned by default. This task may well be more costly than it appears at first blush. The limits of copyright law create an initial barrier to such innovation by denying contractors substantial property rights in their standard form terms. An inherent collective action problem will thus retard the production of innovative, standardized terms for emerging relationships. So long as individual parties are incapable of capturing the full benefits of their innovative expressions, the menu of standard form terms and clauses will be under produced.[28] Over time, of course, the stock of standardized terms and conventions that

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P1 27 This is the same argument that textualists in other areas of law, such as statutory interpretation, have used to reject the use of context evidence such as legislative history to illuminate the text. Under this formalist approach to contract interpretation, a court would enforce a contract--say one in which the seller expressly undertakes to deliver x quantity of goods at y price over z months-- even though changed circumstances, in fact, caused one of the parties to face considerable losses. The argument is that the parties are as familiar as anyone with the risk of changed circumstances and this literal method of interpretation avoids the error that results when courts fill gaps incorrectly. To be sure, this method of interpretation will also generate error, in that courts will not complete contracts in ways that maximize the joint value of the contract to the parties. But this error is predictable and thus the parties can anticipate it and use the predicted and predictable legal outcome as the basis for renegotiating the contract once conditions change. This is a benefit to the parties, one that may outweigh the costs of not trying to fill contractual gaps, especially if the courts lack the competence to engage in socially beneficial gap filling. See Eric Posner, *Relational Contracts and Incompetent Courts* at 3 (manuscript on file).

P1 28 The federal copyright statute offers a seemingly broad and expansive protection for all "original works of authorship". 17 U.S.C. 102 (1982). Nonetheless, it is unclear whether a contract form or term is copyrightable at all. Where, for example, an uncopyrightable idea is so straightforward or narrow that there are necessarily only a limited number of ways to express it, any particular form of expressing that idea will also be

have been tested by judicial interpretation in contract disputes will increase. But the development of an elaborate menu of appropriate express terms and clauses that parties can choose among will nevertheless require the exercise of deliberate (and costly) choice.[29]

Given these trade-offs, the formalist strategy is more or less attractive depending on the competency of courts to perform both core functions-- correct interpretation of contractual text and incorporation of the customs and understandings that are immanent in the contractual context-- at the same time. If these are functions that courts can (and do) perform with relative competence, then the one or the other of the activist interpretive strategies is preferable to formalism. If these are functions that courts do not perform well together, then leaving contextual and other relational norms to be enforced by extra-legal sanctions might actually improve the efficiency of the legal regulation of relational contracts.

In sum, a return to formalism in contract interpretation is best justified on an anti-

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uncopyrightable. The rationale for this limitation is to prevent the underlying idea from being monopolized. See Morrissey v. Proctor & Gamble Co., 379 F.2d 675 (1967). Moreover, even if copyright protection is available for a particular innovative contractual clause, the substantive ideas that it expresses remain public goods. Thus, other parties are free to embody similar contractual provisions in their agreements and may use suitable words to express such provisions. See e.g., Dorsey v. Old Surety Life Ins. Co., 98 F.2d 872 (10th Cir. 1938). Trade secret rules offer no alternative protection for innovative contract terms since it is the breach of confidence by unauthorized disclosure, rather than infringement of a property right that is the gravamen of trade secret liability. See, e.g., Wilkes v. Pioneer Am. Ins. Co.., 383 F. Supp. 1135 (D.S.C. 1974).

P1 [29] This point is a central element in the claim by Jody Kraus and Steve Walt that critics of the incorporation "strategy" have ignored the "specification cost" of alternative interpretive strategies. See Kraus & Walt, *In Defense of the Incorporation Strategy*, supra note ---. To the contrary, however, I have argued in an ealrier paper, and argue again in this essay, that notwithstanding the evident specification costs of a return to formal modes of interpretation, available theory and experience both suggest that the incorporation approach may well be more costly than the more formal, common law alternative. See Scott, *The Uniformity Norm in Commercial Law*, supra note ---at---; text accompanying notes --to--- supra.

imperialistic theory of contract law. On this view, the efficient regulation of contract does not require that every relational norm be judicialized or that the legal mechanism operates efficiently viewed on its own terms, but rather that it operates efficiently in concert with social norms of trust, reciprocity and conditional cooperation that also regulate relational contracts.[30] Under the formalist approach these norms would not be legally enforceable contract terms (unless they were expressly specified in the contract), but they nevertheless would be enforced by social sanctions that would effectively constrain the parties incentives to exploit changed circumstances strategically.[31] Thus, while a modest legal role may appear to be the admission of defeat in resolving the dilemma of relational contracts, in fact, it may be precisely what contracting parties would prefer courts to do.[32]

P1 30 See Robert E. Scott, C*onflict and Cooperation* , supra note —at 2039-42 (1987). Scholars have long recognized that group generated norms, systems of individual ethics and other extra legal mechanisms play important roles in regulating contractual relationships. While we are a long way from an accepted theory of social control, few would quarrel with the claim that social and relational norms serve functional purposes. See, e.g., Krebs & Miller, Altruism & Aggression, in 2 The Handbook of Social Psychology 18-19 (G. Lindzey & E. Aronson 3d ed. 1985); Gouldner, The Norm of Reciprocity: A Preliminary Statement, 25 Am. Sociological Review 161, 172-176 (1960)(norm of reciprocity functions as a stabilizing force, cementing social relationships and discouraging exploitation); E. Walster, G.W. Walster & E.Bersherd, Equity: Theory and Research 6-8, 15-16 (1978) (socially generated norms of equity serve to prevent individuals from following their natural inclinations to maximize their own outcomes at others' expense): Robert Ellickson, Order Without Law (1991) (absent social imperfections–such as the lack of any prospect of a future relationship–the norms that govern relations among members of a group will tend to maximize the aggregate wealth of group members).

P1 31 One explanation for the norms that emerge from business contexts is their utility as supplemental methods of regulating commercial relationships. See generally Alexander, *Evolution and Culture* in Evolutionary Biological and Human Social Behavior 59, 68-69 (198–); Durham, *Toward a Coevolutionary Theory of Human Biology and Culture*,in Evolutionary Biology and Human Social Behavior: An Anthropological Perspective 39, 52 (N.A. Chagon & W. Irons eds. 1979) (because the well-being of individuals depends on the success of their groups, it is in most individuals self interest to accept and obey norms, rules and cultural controls on selfish individual behavior").

P1 32 See generally, Elizabeth S. Scott & Robert E. Scott, *Marriage as Relational Contract*, 84 Va. L. Rev. 1225, 1288-1300 (1998) (discussing the benefits of not judicializing social and relational norms in the marital context).

II. FUNCTIONALISM VERSUS FORMALISM: LESSONS FROM THEORY AND EXPERIENCE

Insights from the Literature on Incomplete Contracts

Recent theoretical literature on the economics of incomplete contracting offers some valuable insights into the reasons for incompleteness and, in turn, suggests the wisdom of a modest and circumscribed role for courts in filling gaps in relational contracts.[33] The analysis starts with a simple question. If incomplete contracts carry such heightened risks of misinterpretation, why don't contracting parties write complete contracts that specify the contract-based conditions that will apply for every possible state of the world?

High transactions costs are the first reason why parties might not write complete contracts. Transactions costs explanations of incompleteness have formed the basis for much of the law and economics analysis of contract law. On this account, parties write incomplete contracts either because a) the resource costs of writing complete contingent contracts to solve contracting problems would exceed the expected gains or would exceed the costs to the state of

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P1 [33] For a representative sampling of the economics literature on incomplete contracting, see Sharon Gifford, *Limited Attention and the Optimal Incompleteness of Contracts*, 15 J.L.Econ.&Org. 468 (1999); J. Thomas & T. Worrall, *Income Fluctuations and Asymmetric Information,* 51 J. Econ.Theory 367 (1991); M. Dewatripont & E. Maskin, *Contractual Contingencies and Renegotiation*, 26 Rand J.Econ 704 (1995); B. Bernheim & M. Whinston, *Incomplete Contracts and Strategic Ambiguity*, 88 Am.Econ. Rev.432 (1998); Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 Econometrica 755 (1988); Oliver Hart, *Incomplete Contracts and the Theory of the Firm*, 4 J.L.Econ.& Org. 119 (1988); G Huberman & C. Kahn, *Limited Contract Enforcement and Strategic Renegotiation*, 78 Am. Econ. Rev. 471 (1988);K.E. Spier, *Incomplete Contracts and Signaling*, 23 Rand J. Econ. 432 (1992); I. Segal, *Complexity and Renegotiation: A Foundation for Incomplete Contracts*, -- Rev. Econ. Studies (forthcoming 1999); B. Hermalin & M. Katz, *Moral Hazard and Verifiability: The Effects of Renegotiation in Agency*, 59 Econometrica 1735 (1991).

creating useful defaults;[34] or b) the parties are unable to identify and foresee uncertain future conditions or are incapable of characterizing complex adaptations adequately.[35]

If transactions costs are preventing the parties from completing contracts with efficient terms, then the state properly should fill the gaps with default terms that solve those problems whenever the state's contracting costs are lower than the contracting costs to the parties. Much of the recent contract theory literature argues, however, that these conditions are hard to satisfy in a large economy with heterogenous parties.[36] Under these conditions, many factors suggest a more modest state role--the more heterogenous are contracting parties the less the scale economies for any default and the greater the likelihood that the state is less capable than the parties themselves in solving their contracting problems. Unless the contracting solution is immanent in the commercial practice and relationship of the parties (as Llewellyn, for example, believed it was), and a court can identify and standardize the practice or experience as a default, a court is likely to create ill-fitting defaults in complex commercial environments.

P1 34 For a discussion in the legal literature, see Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on a Theory of Efficient Breach,* 77 Colum. L. Rev. 554 (1977). For formal analyses that appeal to exogenous transactions costs to explain or justify incomplete contracts, see G. Huberman & C. Kahn, *Limited Contract Enforcement and Strategic Renegotiation*, 78 Am. Econ. Rev. 471 (1988); K. E. Spier, *Incomplete Contracts and Signaling*, 23 Rand J. Econ. 432 (1992).

P1 35 See Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts,* 67 Va. L. Rev.1089, 1092- 1102 (1981). For formal analyses of the effects of uncertainty and complexity, see W.B. MacLeod, *Decision, Contract, and Emotion: Some Economics for a Complex and Confusing World,* 29 Canadian J. Econ. 788 (1996); and I. Segal, *Complexity and Renegotiation: A Foundation for Incomplete Contracts,* —Rev. Econ. Studies— (forthcoming 1999).

P1 36 See Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law,* 3 S. Cal. Interdisciplinary L.J. 389 (1994) and sources cited therein; MacLeod, *Decision, Contract and Emotion,* supra note -- at --.

Asymmetric information is the second reason why parties may choose to write incomplete contracts. Assume, for example, that the parties cannot observe a key economic variable either at the time of contracting or upon renegotiation. Or, in the alternative, even though important conditions can be observed, the parties cannot verify those conditions to courts (the variables are unprovable). Or, finally, the parties may choose for strategic reasons not to disclose private information about themselves.[37] When these conditions of private or hidden information exist, parties would choose to write incomplete contracts even if transactions costs were zero. To do otherwise would require parties to either disclose information that they wish to keep private or to have enforcement turn on facts that one or both could not observe or establish in court. Writing an incomplete contract is preferable to these unpalatable alternatives.

The possibility that contracts are incomplete because of private information or other related factors urges even greater modesty about the state's role in creating useful default rules for relational contracts. The state is incapable of completing contracts with useful default terms whenever contracts are incomplete because of the problems of coping with hidden information. Under these circumstances any contract term selected by a court to fill the gap would have to be based upon information that is either unobservable to the parties or unverifiable to the courts.

P1 [37] Robert E. Scott, *The Uniformity Norm in Commercial Law: A Comparative Analysis of Common Law and Code Methodologies* in The Jurisprudential Foundations of Corporate and Commercial Law, Jody S. Kraus & Steven Walt eds. (Cambridge University Press, forthcoming 2000); Schwartz, *Incomplete Contracts,* supra note – at --; Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 Yale L.J. 729 (1992). For formal analyses of the effects of asymmetric information on incomplete contracting, see Hermalin & Katz, *Judicial Modification of Contracts Between Sophisticated Parties: A More Complete View of Incomplete Contracts and their Breach*, 9 J.L.Econ.& Org. 98 (1993); J. Thomas & T. Worrall, *Income Fluctuations and Asymmetric Information,* 51 J. Econ. Theory 367 (1991); B. Bernheim & M. Whinston, *Incomplete Contracts and Strategic Ambiguity,* 88 Am. Econ. Rev. 902 (1998).

If the parties themselves will choose not to base contractual contingencies on information that is unobservable or unverifiable, they will also choose to opt out of any such state-supplied default terms. Put another way, the state cannot write better contracts than the parties can for themselves in a world of zero transactions costs. Under these conditions, the state simply cannot fill gaps in relational contracts with useful default terms that will solve the parties contracting problems.[38]

This analysis suggests that the traditional law and economics strategy of filling gaps so as to promote ex ante efficiency is likely to be of little utility for parties to relational contracts in a large and complex economy. If the gaps are a product of asymmetric information, then the courts will be incapable of doing what the parties themselves would not do. If the gaps are a product of high transactions costs, then ex ante gap filling will be efficient only where the courts have the capacity and the expertise to incorporate into the contract relevant commercial practice and experience for discrete commercial subgroups. While in theory this second function can and should be a valuable justification for pursuing a gap-filling strategy, as the discussion below will suggest, there are many reasons to believe that successful incorporation does not (and perhaps cannot) occur.

P1 [38] Schwartz, *Incomplete Contracts*, supra note — at —.The problems caused by asymmetric information will preclude courts from creating "problem solving" defaults, but do not, by themselves, preclude efforts to stimulate information exchange between the parties. The rule of *Hadley v. Baxendale* is the most salient illustration of such "information forcing" defaults. Crafting such defaults so as to induce efficient exchange of private information requires that courts have specific information about the relative market power and strategic position of the parties See Scott, *A Relational Theory of Default Rules*, supra note — at—; Ayres & Gertner, *Filling Gaps in Incomplete Contracts*, supra note — at —; Johnston, *Strategic Bargaining*, supra note — at —; Bebchuk & Shavell, *Information and the Scope of Liability*, supra note –at —.

But what about the second approach, the one suggested by the law and society relational scholars: direct courts to seek the ex post efficient result. Once again, modesty in legal intervention is what this literature seems to suggest. If the parties anticipate that the uncertainties they face at the time of contracting will subsequently be resolved, they would logically prefer (and naturally reach) a renegotiation as the optimal mechanism for ex post adjustment. From this perspective, an incomplete contract can be seen as a means by which the parties have chosen to achieve an efficient outcome *ultimately*. If the parties are symmetrically informed ex post, bargaining theory teaches us that they will renegotiate to the efficient result and the dispute will be settled. (In such a world, neither party can exploit the sunk cost investment of the other strategically).

On the other hand, what if the parties expect that their uncertainties will not be resolved as the contract unfolds (that is, information will be asymmetric)? Under these circumstances, they would choose the court as the mechanism to achieve ex post efficiency *but* only if two key conditions are satisfied: a) *the courts will have information at the time of adjudication that the parties lack at the time they attempt to renegotiate: and b) the court could use this information to achieve the right result*.[39]

So, here is the empirical condition that must be satisfied in order to pursue successfully an activist strategy of ex post adjustment: informed and capable courts and uninformed parties.

P1 [39] Schwartz, *Incomplete Contracts, supra note ---at --*.

It is probably the case that our intuitions on the plausibility of this condition divide us to this day. (That is what makes for good academic debate). In my view, the condition is unlikely to be satisfied frequently in practice. The only time courts will be asked to direct the result ex post will be when asymmetric information has caused bargaining breakdown and the court has information that at least one of the parties lacked. But courts are typically informed by the parties, they do not acquire information independently. If this assumption is true, it implies that courts should not attempt to complete contracts ex post either. Under one state of the world it is unnecessary--renegotiation works. And under the alternative state of the world, the courts will lack the data (and perhaps the ability) to do the job.[40]

This analysis suggests that the role courts may have traditionally been asked to assume in specifying default rules ex ante and/ or resolving contract disputes ex post may be far less useful in a complex economy. Moreover, the invitation to courts to create broadly useful defaults or undertake equitable adjustments threatens the parallel goal of predictable interpretation, especially when incompleteness is a product of asymmetric information. Thus, for example, parties may write incomplete contracts that look to renegotiation as the mechanism for achieving ex post efficiency. Under these conditions, the verifiable price and quantity terms in an otherwise incomplete contract may well be designed to form the basis for a renegotiation whenever changed conditions render the agreed upon price and quantity terms obsolete. A court that conditions the enforceability of the price and quantity terms of the contract by completing

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P1 [40] Id.

the contract with a default rule or mandating an equitable ex post adjustment is changing the agreed upon parameters of the anticipated renegotiation.[41]

What then is the most efficacious role for state regulation in a thick environment of many hetergeneous parties who enter into subtly complex, but incomplete, relational contracts? A clue to solving the vexing problem of regulating incomplete relational contracts lies in the fact that both heterogeneity of contracting behavior and heterogeneity of contracting parties argue for preserving the objective instruments for interpreting contracts. Given the difficulty of identifying whether incompleteness is a consequence of high transactions costs or of asymmetric information, and assuming that the state cannot either supply useful defaults or direct efficient outcomes ex post, the best instrumental strategy for courts may well be to accept the limits imposed by formalism and to interpret *literalistically* the facially unambigious terms of the contract. A rigorous application of the common law plain meaning and parol evidence rules would preserve the value of predictable interpretation. Moreover, insofar as courts pursuing this strategy authoritatively interpret commonly used express terms, a formalist approach to interpretation would advance the standardization norm by expanding the established menu of legally blessed standard form terms and clauses.[42]

P1 41 The risk that judicial incorporation of context may inadvertently undermine the parties ex ante risk allocation may explain the well documented anomaly of well-developed legal doctrines of mistake, commercial impracticability, and frustration of purpose and the courts' simultaneous reluctance to excuse nonperformance in particular cases. See Scott, *Conflict and Cooperation,* supra note --- at 2050.

P1 42 Scott, *The Limits of Expanded Choice,* supra note--at--.

A Natural Experiment[43]

The case for formalist interpretation ultimately turns, of course, on the underlying empirical realities. And, so long as those realities remain unknown, any intelligent speculation is just that--speculation. There are some ways, however, to test these theoretical speculations. Perhaps the best natural experiment is to compare the results of courts using a liberal parol evidence and plain meaning interpretive framework to resolve disputed sales contracts under the Uniform Commercial Code with the results of courts interpreting disputed commercial services contracts under the traditional approach of the common law.

Quite clearly, legal modesty in contractual interpretation is not the approach adopted by the UCC. And indeed, casual observation strongly suggests that the risk of unpredictable interpretation has greatly increased for commercial parties under the Code. Courts under the Code have, consistent with its institutional design, interpreted the meaning of express terms in a contract by looking to precisely the same commercial and legal context they use to determine whether to incorporate custom and usage as default rules.[44] This result follows from the

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P1 [43] The following discussion draws upon the analysis in Scott, *The Uniformity Norm in Commercial Law,* supra note —. That paper focuses on an analysis of litigated cases under Article 2 and the common law over the thirty year period from 1969 to 1999 and compares the relative success of both regimes in achieving the substantive values that inhere in uniformity in commercial law.

P1 [44] See, e.g., Brunswick Box Co. v. Coutinho, Caro & Co., 617 F2d. 355 (4th Cir. 1980); Steuber C. v. Hercules, Inc. 646 F2d. 1093 (5th Cir. 1981); Nanakuli Paving & Rock Co. v. Shell Oil Co. , 9th Cir. 1981); Columbia Nitrogen Corp. v. Royster, 451 F2d. 3 (4th Cir. 1971); Modine Mfg. Co. v. North E. Independent School Dist., 503 S.W. 2d. 833 (Tex. Civ. App. 1975).

liberalization of the parol evidence rule under the Code[45], the abandonment of the plain meaning rule[46] and the further direction to courts to construe express terms and the commercial context as consistent with each other.[47] While this last presumption is limited by the corollary that inconsistent usages and experiences should give way to express contractual language, courts have frequently abandoned this principle on the grounds that there is almost always some contextual argument upon which seemingly inconsistent terms can be rationalized. [48] In practice, therefore, the presumption of consistency in the Code, coupled with the expansive definition of 'agreement',[49] has placed a considerable additional burden on parties seeking to opt out of either the legally-supplied defaults or of the commercial context. The verifiable express terms of a

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P1 45 U.C.C. Sec. 2-202 and comments1,2 (1978). The Code (now joined by the Second Restatement of Contracts) reverses the common law presumption that the parties writing and the official law of contracts are the definitive elements of the agreement. Evidence derived from context, including commercial experience and practice, will, under the Code scheme, trigger the incorporation of additional, implied terms. The parol evidence rule under the Code admits inferences from trade usage, prior dealings and course of performance even if the express terms of the contract seem perfectly clear and are apparently "integrated". U.C.C. sec. 2-202 comments1,2; Scott, *The Limits of Expanded Choice,* supra note -- at 273-276.

P1 46 U.C.C. sec. 2-202, comment 1: "This section definitely rejects ...any premise that the language used has the meaning attributable to such language by rules of construction existing in the law rather than the meaning which arises out of the commercial context in which it was used." See also, U.C.C. Sec. 1-205, comment 1: "This Act rejects both the "lay dictionary"and the "conveyancers" reading of a commercial agreement."

P1 47 U.C.C. section 1-205(4).

P1 48 Goetz & Scott, *The Limits of Expanded Choice*, supra note — at 285-286. Professors White and Summers assert that usage and course of dealings " may not only supplement or qualify express terms, but in appropriate circumstances, may even override express terms." They go on to say that "the provision that express terms control inconsistent course of dealing and usages cannot really be taken at face value." James J. White & Robert Summers, *Handbook of the Law Under the Uniform Commercial Code* section 3-3 at 98, 101 (2d ed. 1980).

P1 49 U.C.C. section 1-201(3) defines "agreement" as "the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance as provided in the Act."

relational contract are frequently construed as conditioned on the broader contractual context.[50] Whatever benefits this practice may provide in incorporating commercial context as tailored default terms, it clearly results in less predictable interpretation of express contractual language.

But has activist, contextual interpretation under the Code at least promoted the useful incorporation of "immanent law" (or resulted in efficient equitable adjustment of disputed contracts)? The latter question is not subject to empirical verification, but the former is open to investigation. In a forthcoming paper, I report the results of a systematic examination of the litigated cases under Article 2. [51] A study of these cases reveals that, while the Code was explicitly designed to incorporate evolving norms into an ever growing set of legally defined default rules, incorporation as such has simply not occurred.[52] To be sure, courts have interpreted disputed contracts where context evidence has been evaluated along side the written terms of the contract. But while these decisions affirm the institutional bias toward contextualizing the contract, the fact specific nature of the contract dispute leaves, in virtually every case, little opportunity for subsequent incorporation as default terms suitable for other contracting parties. [53]

P1 50 See cases cited in note --infra.

P1 51 Scott, *The Uniformity Norm in Commercial Law*, supra note -- at —.

P1 52 Id at 26.

P1 53 See cases cited in note--infra. Scott, *The Uniformity Norm in Commercial Law*, supra note-- at--.

It is not surprising that litigation over the meaning of the contract does not provide occasions for incorporating commercial context. These cases typically arise as disputes over the meaning of particular express terms and particular usages and provide little opportunity for announcing generalizable rules whether from an ex ante or an ex post perspective. The vehicle for this latter aspect of the incorporation project, in Llewellyn's mind, was the pervasive direction to courts (a direction found in a majority of the specific provisions of Article 2) to apply the Code provision in question according to the norm of commercial reasonableness.[54]

But this exercise, too, has failed in implementation. A systematic examination of the litigated cases interpreting the Code's "reasonableness" standards reveals that courts have consistently interpreted these statutory instructions not as inductive directions to incorporate commercial norms and prototypes but rather as invitations to make deductive speculations according to "Code policy" or other non-contextual criteria.[55] For whatever reason, courts

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P1 [54] Alan Schwartz & Robert E. Scott, *Commercial Transactions: Principles and Policies* (2ed. 1991). Many of the specific provisions of Article 2 require the parties to obey directives or perform obligations "in good faith" or in a "commercially reasonable" manner. The vague form in which these admonitions are cast works to delegate to the courts the function of announcing the relevant commercial rule. Commercial reasonableness is perhaps the most significant and innovative of these admonitory concepts. Commercial reasonableness is not defined in the Code, but appears prominently in numerous contexts. For example, the Code requires that all "contracts made by a merchant have incorporated in them the explicit standard not only of honesty in fact (1-201), but also of observance by the merchant of reasonable commercial standards of fair dealing in the trade" (sec. 1-203 comment). The notion of commercial reasonableness, inspired by Karl Llewellyn, reflects the legal realists' belief that the law can be (and is) revealed by the behavior and practices of commercial parties. Thus, the admonition to act in a commercially reasonable manner functions for courts as an empirical directive: to decide if the parties have acted in a commercially reasonable manner, the decision maker is asked to look to the marketplace and observe relevant commercial behavior to determine the legal norm. Thus, for example, section 2-609 directs that "commercial rather than legal standards " govern whether grounds for insecurity are "reasonable" or assurances of due performance are "adequate" within the meaning of that section. Id. at 5.

P1 [55] See cases and search strategies discussed in Scott, *The Uniformity Norm in Commercial Law*, supra note - -at 26 and n.44.

charged with the responsibility of implementing the Code's activist policy towards incorporation have declined to do so. In sum, the costs of a strategy of incorporation-- a highly contextualized interpretive methodology that seeks to embed the explicit terms of a contract within a larger commercial context-- seem not to be justified by corresponding enhancements in the supply of useful defaults for appropriate subsets of commercial contractors.

The experience of judicial enforcement of commercial services contracts under the common law over the same thirty year period stands in striking contrast to the litigation under the Code. The interpretive methodology of the common law has stubbornly resisted the contextual modes of interpretation adopted by the Code and the Second Restatement of Contracts. A strong majority of jurisdictions continue to adhere to at textualist interpretation of contract terms, primarily through rigorous adherence to the plain meaning rule.[56] Indeed, traditional conceptions of the parol evidence and plain meaning rules have continuing vitality in many, if not most, jurisdictions. Thus, most courts called upon to interpret commercial services contracts under the common law rules have been unwilling to engage in contextualization. In one way or another they invoke the primacy of express, verifiable contract terms and of the written agreement between the parties.[57]

As might be predicted, one does not see the incorporation of novel default rules in cases

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P1 [56] See cases cited in Goetz & Scott, *The Limits of Expanded Choice*, 73 Calif. L. Rev. at n. 124.

P1 [57] Id.

interpreting commercial services contracts under the common law. Incorporation per se is stymied by the interpretative methodology--a methodology that systematically excludes reference to the commercial context. But the past thirty years has nonetheless seen the development of a rich menu of legally recognized, standardized terms and conventions that are useful to parties in specific service industries.[58] Standardization of express terms has been stimulated in construction contracting, for example, through the offices of key intermediaries such as the American Institute of Architects and the Associated General Contractors. The response of both of these trade organizations to the legal uncertainties caused by the development of the fast-track construction management model of phased construction is instructive.[59] The two rival

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P1 [58] The legal recognition of standardized terms and combinations of terms greatly facilitates the contracting process. Such definitional recognition does not change the optional character of these terms. However, it does confer on them the status of what I have termed "invocations", terms that, once deliberately agreed to, will have a legally circumscribed meaning that will be heavily, perhaps even irrebuttably, presumed. Official recognition of such standardized terms has much the same effect as the seal at common law and the use of standardized terms in corporate indentures. See, e.g., Broad v. Rockwell, Int'l Corp. 642 F. 2d 929, 943 (5th Cir.): "A large degree of uniformity in the language of debenture indentures is essential to the effective functioning of the financial markets; uniformity of the indentures that govern competing debenture issues is what makes it possible meaningfully to compare one debenture issue with another...". Another familiar example is the widely accepted recognition by courts of the standardized meanings attributable to "Incoterms", the international rules for the interpretation of trade terms. See International Commerce Comm'n, Incoterms (1980). See also, Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (Or "The Economics of Boilerplate")*, 83 Va. L. Rev. 713 (1997).

P1 [59] The fast-track method of phased construction has emerged in recent years in response to the combination of high interest rates and rapid cost inflation. Under this method, many construction tasks are initiated before overall design is complete. The economic motive for this accelerated procedure is to minimize both financing costs and inflation of labor and material costs during the construction period. The consolidation of the design and building process is typically combined with the use of a construction manager (or "CM"). The CM combines functions traditionally performed separately by the design architect and the contractor. Thus, the CM participates in the design process by reviewing designs during development, recommending cost efficiencies and design alternatives and proposing construction schedules. Thereafter, the CM serves as a "super general contractor" who coordinates the other contractors work, reviews change orders, super vises contract bids and prepares and revises project budgets.

Using the CM, with its hybrid characteristics, poses difficult contracting problems for the parties. Most importantly, it departs from the traditional owner/architect/contractor structure in which the mutual relationships and obligations have been thoroughly worked out and defined over time. Furthermore, the fast-track procedure is often unusually contentious, placing stress on the legally defined terms of the agreement. The procedure is thus inherently susceptible to contractual disputes over change orders and whether they represent true alterations in the scope of the original work or are merely the finalization of the original plans. See City Stores Co. v. Gervais F.

organizations each produced during the 1970's model contractual forms that defined the contractual obligations and risks associated with the use of a construction manager.[60] In the intervening years, courts have, in the process of adjudicating construction contract disputes, interpreted key provisions of the newly proposed standard forms. Through the process of common law adjudication, these industry-wide prototypes have received plain meaning legal recognition, thereby reducing the risks associated with their use by subsequent contracting parties. [61]

The counter-intuitive result of the common law process is a far greater degree of predictability in interpretation of contractual language *and* an increase in the supply of appropriately tailored default provisions that can be used safely by members of the commercial sub-group. In the case of common law contract adjudication, the incorporation process does not rely on a one-step, self-conscious incorporation of the commercial context by a court. Rather, the common law incorporation mechanism involves two steps. First, the relevant industry or commercial sub-group promulgates standard forms to respond to contracting problems peculiar

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Favrot Co., 359 S0. 2d 1031 (La. Ct. App. 1978); Daugherty Co. v. Kimberely-Clark Corp., 14 Cal. App. 3d 151, 92 Cal. Rptr. 120 (1971).

P1 60 American Inst. of Architects, General Conditions of the Contract for Construction, Doc. Nos. A101/CM, A201/CM,B141/CM, B801; Associated Gen. Contractors, Standard Form of Agreement Between Owner and Construction Manager, Doc. Nos. 8a (1977), 8d (1979), 8 (1980), and 520 (1980).

P1 61 For an example of this testing process in litigation, see e.g., Bolton Corp. v. T.A. Loving Co., 94 N.C. App. 392, 380 S.E. 2d 796 (N.C. Court of Appeals 1989). For a review of the testing of contract terms through arbitration, see Thomas J. Stipanowich, *Beyond Arbitration: Innovation and Evolution in the United States Construction Industry*, 31 Wake Forest L. Rev. 65 (1996). Out of this testing process a set of standardized "official" terms emerges that collectively reduce the risks of writing construction contracts. See Trepasso, *The Lawyer's Use of AIA Construction Contracts*, 19 Prac. Law. 37 (1973).

to the industry. Thereafter, those forms are incorporated into the legal vocabulary, not as default rules, but as additions to the menu of contractual prototypes among which parties within that industry are then free to choose. These model or standard forms thus provide an effective mechanism for internalizing at least some of the benefits from contractual innovation and standardization that private parties may otherwise be unable to capture. By contrast, these standardized options have been far slower to develop under Article 2 of the Code. The National Grain and Feed Association, for example, has elected to opt out of the Code altogether and, through the mechanism of mandatory arbitration, have their standard contract terms subject to a plain meaning interpretation[62].

In sum, while much of the evidence is anecdotal, it points unambiguously to the contrast in outcomes between Code and common law regimes. The common law regulation of contracts for services seems to have created an hospitable legal environment, one that, at the least, seems to support the evolutionary production of standardized and appropriately tailored contract terms. The response of commercial parties–such as the feed and grain industry-- whose contracts nominally fall under the jurisdiction of the Code seems a stark contrast. Opting out of the Code to ensure that contractual language is subject to predictable interpretation is at least some evidence that the costs of a contextualized approach to interpretation are not offset by corresponding gains in the efficient incorporation of industry-specific default terms.

P1 62 See Bernstein, *Merchant Law in a Merchant Court*, supra note — at —.

III. THE (TENTATIVE) CASE FOR FORMALISM

The lesson from theory and experience points toward legal modesty as the superior strategy for courts seeking to regulate relational contracts. Successful incorporation of context, whether to specify efficient default rules ex ante or achieve efficient adjustment ex post, requires that a key empirical condition--*competent courts and incompetent parties*-- be satisfied. Comparing the efforts of courts instructed to engage in activist incorporation with courts instructed to follow constrained modes of interpretation suggests some skepticism about the plausibility of this condition.

There are doubtless many reasons for the failure of the Code to achieve the objectives of its drafters. Quite clearly, one central reason was the failure of the other Code drafters to adopt Llewellyn's proposal that commercial disputes under the Code be resolved by merchant juries.[63] But the failure to provide for the merchant jury is but a symptom of a larger jurisprudential mistake for which Llewellyn must be held at least partly responsible. Llewellyn sought to marry the realist project of incorporating the immanent law with the structure of a uniform code. There is some evidence that the decision to propose a new commercial code was primarily driven by instrumental reasons. Prior efforts to reform the common law of sales along realist lines by

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P1 [63] For a discussion of these and other explanations for the apparent failure of the **C**ode to live up to the aspirations of the "incorporation" project, see Scott, *The Uniformity Norm in Commercial Law*, supra note – at –.

proposed model acts and federal statutes had failed.[64] The codification enterprise seemed a useful mechanism for achieving the desired result: significant changes in substantive law that would be adopted without amendment by most, if not all, jurisdictions. One way to preclude the balkanization of sales law was to propose an "internal" mode of interpretation: specific provisions are to be interpreted according to the broader purposes of the Code itself. [65]

On the other hand, Llewellyn, like most realists, also wanted particular Code sections interpreted in light of the external circumstances as revealed by the behavior of "good" commercial actors. This latter preference explains, in part, the decision to retain the supereminent norm of commercial reasonableness even after the proposal for merchant juries was abandoned. Llewellyn wanted courts to understand that it was desirable to decide specific cases in light of the behavior that they observed in the real world. Thus, section 1-102 provides that the Code "*shall* be liberally construed and applied to promote its underlying purposes and policies" which include "the continued expansion of commercial practices through custom and

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P1 64 Id. at —.

P1 65 A central difference between the uniform commercial statues that preceded the UCC and the new Code lay in the uniquely different interpretive methodologies dictated by a code. A code is a preemptive, systematic and comprehensive enactment of a whole field of law. It presumes to carry within it the answers to all possible questions. Thus, when a court confronts a gap in an incomplete contract, its duty in interpreting a code is to find by extrapolation and analogy a solution consistent with the purposes and policy of the codifying law. The net effect of this institutional design is a highly contextualized interpretive methodology, one that seeks to embed the explicit terms of a contract within the larger jurisprudential context of the Code as well as within the specific commercial context being regulated. Thus, one reason for the unwillingness of the courts to embrace incorporation may be the peculiar distortions created by code methodology: courts are required to interpret the Code's default rules with reference to the hermetic regulatory framework of the Code itself. Code methodology thus stimulates a static equilibrium that impedes the dynamic process by with novel default rules and contract terms evolve. See Scott, *The Uniformity Norm in Commercial Law*, supra note —at—.

usage".[66] But to ensure that all courts would follow that direction (and not use discredited formalist modes of interpretation), section 1-102 also links the reasonableness norm to the overarching goal of making "uniform the law among the various jurisdictions".[67]

The two provisions are not harmonious. The uniformity goal found in section 1-102(2)(c) asks courts to engage in a exercise in generalization: to interpret particular Code provisions according to the general purposes and policies of the Code itself. The incorporation objective of section 1-102(2)(b) asks courts, on the other hand, to engage in a exercise in particularization; to interpret specific Code provisions according to the particular practices of specific commercial subgroups. The result seems to be a confusing signal to courts who have generally chosen the worst of both worlds, resolving interpretation questions by recourse to the contractual context and declining to incorporate context-specific default rules. Thus, the effort to unite instrumental and jurisprudential considerations seems largely to have failed.

The activist interpretive approach embodied in the Code has had several significant effects. One important effect is the observed practice of groups of commercial parties opting out of the Code entirely in important classes of cases. One of the principal reasons for the National Grain and Feed Association's decision to abandon the Code was their desire to have written express terms subject to a formalist and objective interpretive methodology and not to be

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P1 66 Section 1-102(2)(b).

P1 67 Section 1-102(2)(c).

trumped by evidence of course of dealing or usage of trade. [68] Lisa Bernstein suggests that the explanation for this practice lies in the parties desire to separate the legal norms that govern their written agreements from the informal social norms that govern their actions. An alternative (and complementary) explanation, however, is that opting out of the Code permits the grain and feed merchants to secure the economic benefits of legal formalism by substituting a private common law process for the legal activism of the Code.[69]

In any case, what is clear from the data is that the anti-formalist approach embodied in the Code is premised on a notion of trade custom that, in the words of David Charny, relies on "a nostalgia for an idealized, perhaps mythical premodern age–for the intimate local communities of shared value and custom, enforced by knowledge, reputation, and ties of affectional loyalty." [70] What we see instead is the evolution of intermediaries and the development of custom by trade association rule making. Moreover, the rules developed by these intermediaries are themselves formalist. The approach to dispute resolution generated by these local "customs" reveals a preference for literal interpretation of express contract terms and a rejection of context specific "situation sense" analysis of particular contractual relationships.[71]

P1 68 Bernstein, *Merchant Law in a Merchant Court*, supra note —at—.

P1 69 Scott, *The Uniformity Norm in Commercial Law*, supra note—at—.

P1 70 David Charny, *The New Formalism in Contract*, 66 U. Chi. L. Rev. 842, 845 (1999) (declaring that "Llewellyn's antiformalism is a flop").

P1 71 Id. at 846-47. It is important to concede Charny's principal point: the failure of Llewellyn's version of the incorporation strategy does not prove the superiority of a formalist alternative. Moreover, the fact that intermediaries prefer formal mechanisms for resolving disputes within an industry does not, by itself, suggest that

Whether the practice of homogeneous groups of commercial parties opting for formal methods of contractual interpretation reflects an underlying inefficiency in the law is, of course, a complex question. We would first have to know how widespread is the practice that I and Bernstein and others have observed. Thereafter, we must confront in more depth the difficult questions this essay seeks to raise. What are the efficiency values that inhere in contractual interpretation? Can courts do what the functionalist strategies ask of them in a complex environment of heterogeneous contractors? At this point answers to these questions suffer from the defects of a first cut at a difficult problem. Nevertheless, the evidence that incorporation does not work is sufficiently striking to undermine the uncritical assumption of the academic and professional proponents of the Code that an activist role in regulating relational contracts is a priori preferable to the more modest objectives for the state embodied in the common law.

To be sure, building the case against incorporation does not establish the case for formalism. Nevertheless, the objections that have been mounted to date against formalism have largely missed their mark. Formalist interpretation is not an inflexible and wooden application of arid first principles–the criticism launched so successfully at the early formalists. Formalism in relational contract is an interpretative strategy that deserves careful scrutiny to the extent that it is a superior method for reducing the costs of contracting for most parties to commercial contracts.

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the law should copy those forms. The case for formalism must rest, at bottom, on the efficiencies that inhere in formalist contractual interpretation and on the relative inability of courts in complex environments to craft tailored default rules and/or resolve disputes ex post more efficiently than the parties themselves.

Thus, nothing in the case for formalism would preclude judicial policing of firms seeking to using literal language as a vehicle to exploit consumers or other "occasional" contractors. Such a limitation on formal modes of interpretation would be consistent with other, familiar limitations on freedom of contract.[72] For example, one might fear that large firms with high volume and well-developed bureaucratic structures would benefit from formalism in their dealings with smaller firms (or consumers) that contract only occasionally. Reliance on formal terms managed by a bureaucratic infrastructure could be a form of rent seeking in which rivals were disadvantaged by the higher cost to them of formal adherence to the legal norms.[73] There are many responses to this possibility. Industry-specific rules for traders as well as social norms of trust and reciprocity deter much of this behavior, at least among repeat players.[74] Well-developed doctrines of unconscionability are available to police rent seeking by powerful entities. Moreover, the tools of formal language can be used as a sword against rent seeking as well as a shield. One familiar response to the risk of exploitation is legislatively mandated boiler plate–such as the language required to disclaim warranty liability under the Code-- that generates (over time) standardized invocations for shifting common legal risks.[75]

P1 72 For a detailed analysis of the historic willingness of contract law to embrace arguments for limiting itself, see Robert E. Scott & William J. Stuntz, *Plea Bargaining as Contract*, 101 Yale L. J. 1909, 1918-1935 (1992).

P1 73 Charny, *The New Formalism*, supra note – at –.

P1 74 See e.g., Macauley, *Non-Contractual Relations in Business*, supra note -- at —.

P1 75 See, e.g., UCC 2-316(2) ("to exclude or modify the implied warranty of merchantability ...the language must mention *merchantability...*") (emphasis added).

Nor is it a fair objection to the case for formalism that the world of incomplete contracting is more complex than the arguments for formalist interpretation recognize. To be sure, an activist interpretive strategy is appropriate under certain empirical assumptions. Karen Eggleston, Eric Posner and Richard Zeckhauser argue, for example that ex ante gap filling is appropriate where the asymmetry of information and bounded rationality that hamper the contracting parties ex ante is more severe than the information and rationality problems that hamper courts ex post.[76] As we have seen, these conditions are unlikely to be satisfied in contracts between sophisticated commercial parties and more likely to be found in contracts with consumers or other single-shot contractors. They propose a legal regime in which courts elect between literal and aggressive modes of interpretation depending on the underlying causes for the simplicity of the contract. But if courts are sufficiently competent to make those kinds of judgments, then they are clearly competent to adopt a single formalist mode of interpretation and deploy other contract doctrines–such as unconscionability– to guard against rent seeking or other exploitative behavior by firms with informational advantages. Moreover, particular contracting parties should always be free to opt out of formalism (by appropriately clear contractual language) and choose instead more contextualized forms of interpretation instead.

P1 76 Karen Eggleston, Eric A. Posner, and Richard Zeckhauser, *Simplicity and Complexity in Contracts* (unpublished paper on file) at 38.

CONCLUSION

The central claim of this essay can be stated quite clearly. Formalist modes of interpretation are justified because and only because they offer the best prospect for maximizing the value of contractual relationships, *given the empirical conditions that seem to prevail*. The apparent failure of the grand experiment in functional interpretation under the Code does not prove that the incorporation project was misguided in principle.[77] It merely suggests that implementing such a project may require a more complex institutional design than courts are able to handle competently. Thus, at bottom the case for formalism in relational contract turns on the relative implausibility of the empirical conditions necessary for activist incorporation: *competent courts and incompetent parties*. The evidence from the cases adjudicating contract disputes under both the Code and the common law is that the more likely empirical condition is *competent parties and incompetent courts*. The common law interpretive methodology is grounded on the implicit assumption that courts function well when they operate within tightly constrained, formal modes of analysis. Courts will perform poorly, on the other hand, where they attempt the typically legislative tasks of harmonizing value conflicts and actively regulating complex economic activity. This essay offers some evidence of the wisdom of the common law.

P1 [77] See Kraus & Walt, *In Defense of Incorporation,* supra note—at—.