

2004

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Recommended Citation

Avery W. Katz, *The Relative Costs of Incorporating Trade Usage into Domestic Versus International Sales Contracts*, CHICAGO JOURNAL OF INTERNATIONAL LAW, VOL. 5, P. 181, 2004; COLUMBIA LAW & ECONOMICS WORKING PAPER NO. 243 (2004).

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Working Paper No. 243

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January 2004

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The Relative Costs of Incorporating Trade Usage into Domestic versus International Sales Contracts

[Comments on Clayton Gillette, “Institutional Design and International Usages under the CISG”]

Forthcoming in *Chicago Journal of International Law*, Spring 2004, vol. 5 , no. 1.

Avery Wiener Katz*
January 2004

Clayton Gillette’s paper on the use of trade usage in reported disputes arising under the Convention on the International Sale of Goods (CISG) presents a challenge to recent scholarly critiques of modern contractual interpretation.¹ As Gillette explains, much recent writing by economically influenced U.S. scholars in contracts and commercial law has argued in favor of more formalistic methods of interpretation, and against the overwhelming trend of the last half of the twentieth century toward a more contextual interpretative approach that takes into account a variety of evidence including the business purpose of the transaction, the customs and practices of the market in which the parties transact, the history of the parties’ dealings, and even the parties’ pre- and post-contractual communications.² This critique has extended

* Professor of Law, Columbia University School of Law. E-mail: avkatz@law.columbia.edu. I am grateful for helpful discussions with Clayton Gillette and Lisa Bernstein, and with other participants in the conference on “The Empirical and Theoretical Underpinnings of the Law Merchant.” This paper is a preliminary draft; please do not cite it without permission of the author. The most current version of the paper can be found online at <http://www.columbia.edu/~ak472/#Papers>.

1. Clayton P. Gillette, *The Law Merchant in the Modern Age: Institutional Design and International Usages under the CISG*, 5 *Chi. J. Int’l Law* __ (2004).
2. Gillette, *supra*, note 1, at x. The leading exponents of this position include Alan Schwartz, *Relational Contracts and the Courts: An Analysis of Incomplete Contracts and Judicial Strategies*, 21 *J. Legal Stud.* 271 (1992); Lisa Bemstein, *Merchant Law in a Merchant Court: Rethinking the Code’s Search for Immanent Business Norms*, 144 *U. Penn. L. Rev.* 1765 (1996), Alan Schwartz, *Incomplete Contracts*, 2 *New Palgrave Dictionary of Economics and Law* 277 (1997); Lisa Bernstein, *The Questionable Empirical Basis of Article 2’s Incorporation Strategy: A Preliminary Study*, 66 *U. Chi. L. Rev.* 710 (1999); Richard A. Epstein, *Confusion about Custom: Disentangling Informal Custom from Standard Contractual Provisions*, 66 *U. Chi. L. Rev.* 821 (1999); Robert E. Scott, *The Uniformity Norm in Commercial Law*, in Jody S. Kraus and Steven D. Walt, *The Jurisprudential Foundations of Corporate and Commercial Law* 149 (2000); Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 *Nw. U.L. Rev.* 847 (2000), Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 *Col. L. Rev.* __ (2003); Robert E. Scott and Alan Schwartz, *Contract Theory and the Limits of Contract Law*, 113 *Yale L.J.* ____ (2003).

even to the interpretative use of trade usage, which has long been regarded as an especially reliable source of information about the parties' intentions and which enjoys a privileged status in US domestic sales cases decided under the Uniform Commercial Code.³

Gillette argues, based on a survey of international case law, that Article 9(2) of the CISG, which directs tribunals to incorporate international trade usage into private contracts governed by the Convention unless the parties agree otherwise, works well in practice and has not led to the adverse consequences of which formalist critics have warned. This Comment expands upon Gillette's argument to provide a more robust account of when substantive interpretative doctrines such as trade usage might be desirable, and why such doctrines appear to be especially useful in the transnational setting of the CISG. In my view, Gillette's account is incomplete because it does not provide an explanation of why international tribunals have not fallen prey to the temptations of more substantive interpretation in the way that US domestic courts have, and because he focuses primarily on the costs of interpretative uncertainty to the exclusion of a fuller list of costs and benefits relevant to the choice of interpretative regime. Taking this list of considerations into account renders more comprehensible the widespread use of trade usage and similar contextual standards in the transnational setting, and reinforces Gillette's conclusions regarding trade usage's commercial functionality.

1. The debate over formal versus substantive interpretation

The basic argument made by contemporary formalist scholars in the field of contracts and commercial law is that trade usage, even when it exists, is considerably more complex, subtle and heterogeneous than mainstream scholars and commentators have appreciated, and that much regularly observed behavior reflects not compliance with what the parties regard as customary legal obligation, but rather a conscious departure from those obligations for

3. Under UCC 1-201(3) and 1-205, trade usage (along with course of dealing and course of performance) supplements and gives meaning to the particular terms of every agreement governed by the Code; and under UCC 2-202, the same sources of evidence are always available, in contrast to parol evidence, to explain or supplement the agreement, even if the agreement appears clear on its face.

purposes of business goodwill or in implicit settlement of a potential contractual dispute. Generalist courts deciding disputed cases *ex post*, on this view, are unlikely to be able to observe and understand this complex environment with the accuracy that is needed for their interventions to be helpful. Additionally, relying on the work of Lisa Bernstein in particular, these critics have argued that the value of commercial certainty and the need to maintain a strict separation between legal obligations and social regularities conferred as a matter of grace are so great as to foreclose inquiry into trade usage even where the adjudicators are themselves experienced trade participants.⁴

The growing influence of this formalist thesis in the US scholarly literature stands in sharp contrast to the view of most international commercial lawyers and scholars, who are accustomed to a legal regime in which courts and arbitrators routinely consider contextual factors such as trade usage and apply open-textured legal standard such as good faith when rendering their decisions. As Gillette observes, on the new formalists' logic, international commerce presents a particularly inapposite arena for substantive interpretation. The ability of generalist arbitrators and decentralized national courts usefully to apply contextual standards is likely to be substantially diminished in an environment characterized by greater heterogeneity among traders, relative infrequency of repeat dealings, and linguistic, cultural and geographic distances that make it more difficult for the adjudicators — or indeed, the traders themselves — to observe and communicate about business practice.

Nonetheless, the CISG, an international treaty drafted with the participation of business advisory groups and adopted with the consent of a heterogeneous set of national actors, incorporates a variety of contextual legal standards that depends on *ex post* substantive interpretation for their content. These include not just the trade usage provision of Article 9(2), but also provisions that prescribe a reasonableness test for all interpretative questions,

4. See Bernstein, *The Questionable Empirical Basis of Article 2's Incorporation Strategy*, *supra*, note 2; Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 *Mich. L. Rev.* 1724 (2001).

that allow contractual liability to be imposed without any formal writing requirement, that direct tribunals to interpret the entire Convention in light of unspecified standards of good faith in international trade, that indicate that questions not expressly settled in the CISG should be settled by reference to the general principles on which it is based, and that direct tribunals to consider all relevant evidence in interpreting the parties' intentions and expectations, including even communications that would be barred as parol evidence under common law systems.⁵ Furthermore, to my knowledge, there is no apparent pattern of attempts by contracting parties to opt out of the Article 9(2)'s trade usage provision, even though such opt-out clauses are explicitly authorized by Article 6, and even though parties regularly include in their contracts merger and entire-agreement clauses that exclude pre-contractual communications from the interpretative process.

If the formalist critics are right, then there is something seriously wrong with international commercial law practice; and conversely if the international commercial law elites are right, there is something wrong with the formalist critique. With this dichotomy as background, Gillette pronounces the CISG's more substantive approach to trade usage to be a success, which he attributes to three main factors. First, few cases are litigated, so that the chances are low that the costs of substantive inquiry will actually be incurred *ex post*. Second, the same features of international trade that make it difficult to determine trade usages in the first place also imply that most cognizable usages will be generated by mercantile associations such as the ICC that have the ability and incentive to disseminate efficient usages that can be applied in straightforward fashion. And third, the courts and arbitrators that are called upon to apply trade usage under Article 9(2) have chosen to be restrained in doing so, perhaps because of their understanding of the needs of international commerce, and perhaps in deference to the

5. See CISG Article 7(1) [interpretation in light of good faith], Article 8(2) [reasonableness standard for interpretation], Article 7(2) [questions not expressly settled in the CISG to be settled in conformity with the general principles on which it is based], Article 8(3) [due consideration to be given to all relevant circumstances including pre-contractual negotiations], and Article 11 [no formal requirements for proving or evidencing contracts, including a writing, except for contracts involving countries that expressly entered reservations to this Article at the time they ratified the CISG]

textual requirement of Article 9(2) that limits consideration to trade usages that have an international character.

My own resolution of the apparent conflict between the scholarly critique and transnational practice comes down more or less where Gillette's does, but for a somewhat different set of reasons. In particular, Gillette's account of the incentives of courts and arbitrators in international commercial disputes is undeveloped, and so gives little reason for confidence that those tribunals will continue to be restrained in their use of contextual evidence in the future or when applying different doctrinal provisions such as good faith and course of dealing. I do agree with Gillette that incorporating trade usage and using other contextual standards is likely to be less costly and more sensible in the CISG setting than in the UCC setting out of which the formalist critique originally arose, but this is the case because of a more systematic set of considerations than he provides here.

As I have argued elsewhere, the optimal choice between form and substance in contract interpretation depends on a tradeoff among a variety of diverse planning and incentive considerations.⁶ These considerations include the costs of writing more detailed contracts *ex ante*, the costs of rent-seeking both *ex ante* in contractual negotiations and *ex post* once a dispute has arisen, the principal parties' ability to provide their legal and business agents with proper incentives to enter into contracts on efficient terms, the parties' attitudes toward risk and the distribution of information among potential tribunals, the need to make specific investments whose value depends on a particular contractual interpretation, and the need to induce complementary investment by third parties who may have differential access to the

6. Avery Wiener Katz, *The Economics of Form and Substance in Contract Interpretation*, 104 *Col. L. Rev.* ___ (forthcoming 2004). My article is hardly the first to argue against the formalist critique on economic grounds, but it does offer a more thorough survey of relevant economic considerations than previous work. For other economically influenced scholars taking a skeptical position on interpretative formalism, see Jody Kraus, *Legal Design and the Evolution of Commercial Norms*, 26 *J. Legal Stud.* 377 (1997); Eric A. Posner, *The Parol Evidence Rule, the Plain Meaning Rule, and the Principles of Contractual Interpretation*, 146 *U. Pa. L. Rev.* 533 (1998); and Jody S. Kraus and Steven D. Walt, *In Defense of the Incorporation Strategy*, in Jody S. Kraus and Steven D. Walt, *The Jurisprudential Foundations of Corporate and Commercial Law* 193 (2000).

formal and substantive aspects of the principal parties' agreement. As a result, the formalist argument against substantive interpretation does not hold generally, but only in those cases where the interplay of these considerations renders the benefits of formality greater on balance than its costs. It is for this reason that I recommend that the choice between formal and substantive modes of interpretation be left to the contracting parties themselves, who are likely to be in much better position to evaluate these considerations than are courts, legislatures, or diplomats negotiating international treaties.

Thus, when Gillette states that incorporation of trade usage makes sense where third-party tribunals can identify relevant usages and verify compliance with them at reasonable cost and accuracy, he focuses only on one of these considerations.⁷ For his conclusion to be correct, his generalization needs to be understood in relative or other-things-being-equal terms— that is, that incorporating trade usage makes sense when tribunals can apply it at relatively reasonable cost and relative accuracy, compared with other the costs of using trade usage in the interpretative process as opposed to following a more formal “plain meaning” rule.

2. Comparative advantages of substantive interpretation in the international setting

Starting from this more systematic framework for balancing the costs and benefits of formality, one can identify a more robust set of explanations why sophisticated commercial parties engaging in international transactions are willing to tolerate more substantive methods of interpretation in general and freer use of trade usage evidence in particular. These explanations do not depend on the presumed grace or good judgment of arbitrators or judges— such a presumption might happen to be warranted in practice but surely is not in principle— nor on the peculiarities of the process by which international trade usage is developed. Rather, they stem from the different relative costs and benefits of dispute resolution and contract writing that obtain in the international setting.

7. Gillette, *supra*, note 1, at 11.

Specifically, there are at least four overlapping reasons why the cost of considering trade usage and other contextual evidence will be less in international sales transactions than in the US domestic setting out of which the new formalist scholarship has arisen. These are: first, a greater leeway for the parties to contract out of tribunals and usages that are likely to apply most inefficiently to their particular situation, second, the simpler and cheaper procedures available in international compared to US domestic litigation, third, the routine use of commercial letters of credit for international payment, and fourth, the relative unimportance of variable as opposed to fixed costs in international dispute resolution.

Freedom to choose governing law and venue for litigation. In the arena of international sales contracts, it is relatively easy for the parties for the parties to opt out of substantive interpretative regimes if they wish, either through explicit choice of governing law, or through forum clauses that will ensure that any dispute is heard by a tribunal that is more responsive to their business concerns. The rules and culture of international private law have long taken a liberal attitude toward the parties' contractual choice of applicable law; and the CISG follows in this tradition, specifically authorizing parties in Article 6 to exclude the application of the entire convention from their contract, or, less drastically, to derogate from or vary the effect of any of its provisions, including the trade usage provision of Article 9(2).⁸

In contrast, while in the US domestic setting it is theoretically possible for parties to exclude particular trade usages from their sales contracts under UCC §§1-205 and 2-208, in

8. There are some minor limitations on this power to derogate from the individual articles of the CISG. The parties may exclude the application of this Convention or, subject to article 12, derogate from or vary the effect of any of its provisions. Specifically, where one of the parties to the contract has its place of business in a State that has made a reservation under article 96 relating to the question of whether a contract must be formally evidenced by a writing in order to be enforceable, the parties may not agree to dispense with the writing requirement that their home state has retained; and in addition, the parties cannot derogate from the public international law provisions of Articles 89-101, as these provisions cover issues relevant to contracting States rather than private parties.

Additionally, the question has arisen in case law whether parties wishing to opt out of the CISG must do so explicitly or may do so implicitly. It has been generally held, however, that a clause which states that "this contract is governed by the laws of state X," where state X has joined the CISG, does not suffice to exclude the CISG's applicability, unless the clause refers specifically to state X's domestic law only.

practice it is often difficult for parties to tell when and whether they have effectively done so. Under these provisions, courts are directed to construe express contractual terms as consistent with trade usages, courses of dealing, and courses of performance wherever possible, and to exclude the application of these supposed background norms only when they cannot reasonably be construed as consistent with express terms. Following the apparent intention of the statutory drafters, US courts have bent over backwards to find consistency between express terms and trade usage, denying summary judgment, for instance, in cases where a litigant claimed that trade usages belied apparently clear contractual clauses providing for fixed quantity or fixed price terms.⁹ Furthermore, UCC Article 2 offers no authorized way generally to exclude trade usages and courses of dealings in the manner of CISG Article 6; if the parties want to exclude usages they must do so explicitly and by specific reference, which is obviously much more costly and cumbersome.

Similarly, parties' ability to opt out of substantive interpretation regimes through choice of law and forum selection clauses is more limited in the US domestic than in the international arena. In addition to the more liberal tradition of freedom of contract that usually obtains in transnational cases, in the domestic sales context sales contracts are governed by a uniform statute in force in all 50 states and the District of Columbia. Thus, US parties cannot avoid the application of the UCC if they want to have their dispute heard by a court, in the way that transnational litigants can opt into a more formal regime by providing for their contract to be interpreted under the laws of England and enforced by a tribunal sitting in London .

This greater freedom of contract in the international setting both provides a safety valve for those parties who would be most disadvantaged by a substantive interpretative regime, and gives international tribunals a competitive incentive to keep their interpretative inquiries

9. See *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 quantity terms in written contract were actually buyers' options); *Nanakuli Paving and Rock Co. v. Shell Oil Co., Inc.*, 664 F.2d 772 (9th Cir. 1981) (trade usage and course of dealing admitted into evidence to show that price was to be measured at time of contract despite express term fixing price as of delivery). See also cases discussed in Scott, *supra*, note x.

within limits if they want to enjoy continued business. For both reasons, it is less costly, other things being equal, for international parties to operate under a trade usage regime than it would be in the US domestic setting.

Lower procedural costs in considering context evidence. In addition to the possibility of opting into more formal substantive legal rules, transnational commercial litigation also gives the parties access to institutional proceedings that are generally less complicated and costly than US legal forums. Commercial litigation under UCC Article 2 is governed by the standard set of American civil procedures, which include extensive pretrial discovery and the constitutional right to a jury. Whatever their other merits, these procedures raise the cost of litigation by providing greater opportunity to develop and introduce evidence and by diminishing the likelihood that the case can be resolved on the pleadings or at summary judgment. They also increase the uncertainty of the outcome by committing critical factual determinations to an amateur tribunal that lacks both commercial or legal experience. For both reasons, US procedures make the incremental costs of substantive interpretation especially large.

In international litigation conducted outside United States courts, in contrast, the scope for investigating contextual matters is comparatively limited; and the relatively high cost of transporting witnesses or experts makes in-person testimony relatively infrequent, so that judgment is often rendered based on written submissions. Under such circumstances, allowing trade usage and similar contextual evidence to be admitted may increase litigation costs by a relatively small amount. Additionally, since the agent charged with the task of interpreting the agreement will usually have extensive legal expertise (and in the arbitral setting, commercial expertise as well), the potential variance among tribunals in assessing such evidence, as well as its associated transaction costs of risk-bearing and settlement negotiations will also be relatively low.

Letters of credit as a backup enforcement mechanism. In many if not most international sales cases, the threat of going to court is not the parties' primary enforcement device. This is because the parties typically arrange for payment through the device of a commercial letter of credit (CLC), under which a buyer of goods engages an issuing bank to promise to pay the seller upon presentation of documents showing that the goods have been shipped. In addition to providing a medium for transmission of funds, the CLC also affords an alternate, inexpensive and formal method of dispute resolution, because given the costs of bringing a lawsuit in a distant and possibly inhospitable location, the seller's ability to obtain payment will often determine the outcome of any dispute. And in contrast to the relatively contextual legal standards provided by the CISG, the law governing letters of credit is quite formalistic. According to the basic principle of letter-of-credit law (denoted the "independence principle" by scholars in the field) the beneficiary's rights against an issuing bank depend only on its compliance with the documentary conditions of the letter under which it seeks payment. The beneficiary does not otherwise have to prove its entitlement to payment, and the issuer does not have to (and in general is not allowed to) investigate the substance of the underlying transaction before paying. The formal nature of letter-of-credit law thus lowers the effective costs of substantive interpretation in cases going to trial or arbitration. Judges and arbiters in international disputes can thus better afford to apply substantive standards of interpretation because they know that the letter-of-credit device is operating as a backup for them, perhaps in the same way that trade association arbitrators in the US can afford to operate in a formalistic way because non-legal sanctions applied by the relevant commercial community are available to enforce the more substantive aspects of parties' obligations.¹⁰

10. See generally Bernstein, *supra*, note 4 (stating both that trade arbitrators apply a formalistic approach to interpretative questions and that non-legal sanctions, not arbitral awards, actually provide the main incentive to keep one's commercial commitments.) Note also that the mechanism that Bernstein identified as backing up the incentive to comply with trade usage — reputation and the resultant threat of losing repeat or referral business — is substantially weakened in the international setting where communication networks are more diffuse and repeat dealing is less common.

High fixed cost of litigation. Finally, whatever the ex post costs of considering trade usage, parties will be more willing to bear them in international setting because they are relatively small compared to the fixed cost of litigating in the first place. Pursuing a dispute internationally is more costly than pursuing one domestically, other things being equal, because of the need to transport lawyers, witnesses and evidence to a distant location for litigation and to hire arbitrators or local counsel, and because of the difficulty of collecting any monetary award in a foreign jurisdiction. As indicated previously, these high costs explain why low-cost dispute resolution mechanisms such as letters of credit and arbitration are popular in the international setting and why litigation is relatively rare. Nonetheless, in some cases it is necessary to litigate and to spend the associated resources in doing so. Because many of these expenditures are fixed in amount and do not depend on the intensity of litigation, however, the incremental cost of considering additional evidence given that there is already going to be litigation is relatively low. More generally, it makes sense to litigate more intensively in litigation that is characterized by higher stakes or higher overhead costs, and in the international setting it is these cases that are typically brought before arbitrators or courts.¹¹

3. Conclusion

Gillette is correct both when he argues that the value of incorporating trade usage into contractual interpretation depends on the business and institutional context, and when he

11. This implication is a special case of what Chicago-trained economists know as the Alchian-Allen theorem, which holds that when transportation costs are fixed, market forces will lead to goods of relatively high quality trading across distances and goods of relatively low quality trading near home, because fixed transportation costs mean make the relative price of quality higher near the source than farther away. See Thomas E. Borchering and Eugene Silberberg, *Shipping the Good Apples Out: The Alchian and Allen Theorem Reconsidered*, 86 *J. Pol. Econ.* 131 (1978) (analyzing the argument formally and concluding that it is a useful generalization, if not a logical implication of economic theory); Eric P. Bertonazzi, Michael T. Maloney, and Robert McCormick, *Some Evidence on the Alchian and Allen Theorem: The Third Law of Demand?* 31 *Econ. Inquiry* 383 (1993) (presenting empirical evidence confirming the generalization); David L. Hummels and Alexandre M. Skiba, *Shipping the Good Apples Out? An Empirical Confirmation of the Alchian-Allen Conjecture*, National Bureau of Economic Research Working Paper No. W9023 (June 2002) (same).

argues that the international context is different in this regard in the setting of international sales transactions. Understanding why the international context is different, however, requires a considerable amount of attention to the details of that context. Indeed, because of the difficulty of generalizing about the costs and benefits of formality, scholars should be more restrained about recommending formal regimes of interpretation beyond their ability to be certain that the resulting net benefits are really positive. A more defensible approach would be to advocate making it easier for contracting parties to choose an interpretative regime for themselves; and this is in fact what the CISG does for them in most respects.