TEXT *AND* CONTEXT: CONTRACT INTERPRETATION AS CONTRACT DESIGN

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Contract interpretation remains the most important source of commercial litigation and the most contentious area of contemporary contract doctrine and scholarship. Two polar positions have competed for dominance in contract interpretation. In a textualist regime, generalist courts cannot consider context; in a contextualist regime, they must. Underlying this dispute are contrary assumptions about the prototypical contract each interpretive style addresses. For modern textualists, contracts are bespoke, between legally sophisticated parties who embed as much or as little of the contractual context as they wish in an integrated writing and prefer to protect their choices against judicial interference by an interpretive regime including the parol evidence and plain meaning rules. For contextualists, in contrast, contracts are between legally unsophisticated parties in two prototypical settings. The first is the mass-market, standardized contract between sophisticated sellers and unsophisticated consumers, who cannot bargain over contractual terms; the second involves commercial parties doing business in a deeply nuanced world where formal and informal understandings mix and the meaning of a particular contract can be illuminated by the parties' course of dealings. For the contextualist, willfully restricting a court's access to information bearing on the parties' real relationship in both cases degrades judicial interpretation.

We argue that the narrow focus on which prototype should apply universally has erroneously framed discussion of the parties' choices and led to an inconclusive and limited debate about the role of courts in contract interpretation. The range of options for parties and generalist courts is much more diverse and variegated than the choice between ex ante party autonomy and ex post adjudication. We present a typology of transactional settings—the design space for contracting—sufficiently rich to capture the breadth of current contractual experience but sufficiently parsimonious to clarify the central relationship between the factors that shape the design of any given contract and the role of courts in interpreting it. We show that design and judicial response depends, first, on the level of uncertainty and, second, on the thickness of the market—whether there are many traders or few engaged

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in a similar class of transactions. The higher the level of uncertainty, the less workable complete, state-contingent contracts become, and the more parties develop interpretive mechanisms based on rich and regular exchange of information on a project's progress that allows each to gauge the other's capacity to define and produce a product. The greater the number of traders engaged in a transaction, the more likely that the interpretive regime—terms adapted to current need—will be provided by a trade association or, given collective action problems, a public regulator. The interplay of uncertainty and scale illuminates new forms of contracting among legally sophisticated parties unanticipated in discussions of textualist prototypes and recasts the contextualist prototypes as special cases that demand novel institutional responses, including generalist courts sufficiently versed in the parties' practices that they resemble early courts of equity. More generally, our analysis reveals a surprising complementarity between public regulation and common law adjudication in a variety of settings. Contractual interpretation today should attend to today's contracts and courts; our aim is to escape the stalemate between textualists and contextualists and open the way for doctrine and debate to support the novelty of contemporary contracting practices.

INTRODUCTION

Contract interpretation remains the most important source of commercial litigation[1] and the least settled, most contentious area of contemporary contract doctrine and scholarship.[2] Framed by the battle between the titans of contract, Samuel Williston and Arthur Corbin, and continuing to the present, two polar positions have competed for dominance in contract interpretation. In a textualist regime, generalist courts cannot choose to consider context; in a

[1] Judge Richard Posner has estimated that many of the contract cases he sees present interpretation disputes. *See, e.g.*, Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1582 (2005). An early empirical study found that 25.8% of a sample of 500 cases raised interpretation and parol evidence issues. *See* Harold Shepherd, *Contracts in a Prosperity Year*, 6 STAN. L. REV. 208, 222–24 (1954); *see also* David A. Dilts, *Of Words and Contracts: Arbitration and Lexicology*, 60 DISP. RESOL. J. 41, 43 (2005) ("The construction of contract language is the controversy most evident in contract disputes."); John P. Tomaszewski, *The Pandora's Box of Cyberspace: State Regulation of Digital Signatures and the Dormant Commerce Clause*, 33 GONZ. L. REV. 417, 432 (1998) ("Most contract litigation involves disputes over construction of the terms in a contract.").

[2] *See infra* notes 3–9 and accompanying text; *see also infra* Part I.A–B.

contextualist regime, these courts must consider it. Thus, text or context.

Underlying this dispute are contrary assumptions about the prototypical contract each interpretive style addresses. For the nineteenth-century forerunners of the modern textualists, the key prototype was a contract for commodity futures, a bargained-for, voluntary agreement between fully informed and competent parties, embodying crossed promises, at least one of which is to be executed in the future, and establishing the idea of expectation damages derived from plausible calculations about the gains of a forgone transaction.[3] Their twentieth-century intellectual heirs broadened the prototypical transaction to include all bespoke or state-contingent contracts in which the parties, aided by counsel, are legally sophisticated—capable of designing ex ante contracts that will put them in the best available position to respond to whatever eventuates.[4] Because they are able to embed as much or as little of the contractual context as they wish in a written, integrated contract, legally sophisticated parties are more likely to resent than to welcome a court's efforts to supplement or circumvent their original design by its own contextual investigation. Hence, these sophisticated parties prefer textualist interpretation, as embodied in the parol evidence and plain meaning rules and the effect of integration, anti-waiver, and modification clauses.[5] These doctrines direct courts to look to a contract's formal language and disregard claims, unless anchored in the text, that the parties intended to assign contract terms a special meaning revealed by the course of dealings or other feature of the context of their relation, or otherwise intended to supplement the formal contract by unwritten understandings and undertakings.[6]

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3 *See* Morton J. Horwitz, *The Historical Foundations of Modern Contract Law*, 87 HARV. L. REV. 917, 936 (1974); Robert E. Scott, *The Death of Contract Law*, 54 U. TORONTO L.J. 369, 371 (2004).

4 *See* Alan Schwartz & Robert E. Scott, *Contract Interpretation Redux*, 119 YALE L.J. 926, 957–63 (2010).

5 There are good reasons to believe that commercially sophisticated parties prefer a regime that follows the parties' instructions specifying when to strictly enforce formal contract terms and when to delegate authority to a court to consider surrounding context evidence. *See* Geoffrey P. Miller, *Bargains Bicoastal: New Light on Contract Theory*, 31 CARDOZO L. REV. 1475, 1478 (2010). By eliminating the risk that courts will erroneously infer the parties' preference for contextual interpretation, such a regime reduces the costs of contract enforcement and enhances the parties' control over the content of their contract. That control, in turn, permits sophisticated commercial parties to implement the most efficient design strategies available to them. Ex post, preferences may change for the party disfavored by the resolution of uncertainty, who may then prefer the right to persuade a court of a different result. Of course, that is the point of the ex ante focus. *See infra* notes 50–61 and accompanying text.

6 A strong majority of U.S. courts continue to follow the traditional, textualist or "formalist," approach to contract interpretation. A state-by-state survey of recent court decisions shows that thirty-eight states and the District of Columbia follow the textualist ap-

Contextualist interpretation, in contrast, directs courts to determine whether extrinsic evidence of the circumstances surrounding the contract or its performance improves understanding of what parties intended regardless of the contractual text. For contextualists, the prototypical contractual transaction is one in which one or both parties are, or for that contract choose to be, *legally unsophisticated*: unable or unwilling to incur the expense to express their undertakings in contract language, and therefore reliant on the equitable judgments of courts in case of disputes. Contextualists argue that the court's untrammeled authority to consider context is important in two core prototypical settings. The first is the mass-market, standardized contract between sophisticated sellers and unsophisticated consumers, who do not or cannot bargain over contractual terms. Extending the court's inquiry beyond the contract's four corners is necessary to prevent such necessarily passive parties from exploitation through adhesion to formal contract terms that do not reflect their real intentions.[7]

The second core contextualist prototype involves commercial rather than consumer contracting. As stressed by Karl Llewellyn and partially reflected in the Uniform Commercial Code (U.C.C.), many commercial parties do business in a deeply nuanced world where formal and informal understandings mix in a mélange of explicit terms and underlying practice whose joint application to the particular contract can be illuminated by the parties' course of dealings.[8] In this setting parties who are sophisticated about their business choose to be legally unsophisticated in the sense of avoiding ex ante design: the stakes in any given transaction are generally insufficient to justify bespoke contracting aided by legal counsel. Instead, the parties prefer to entrust adjudication, including determination of the details of the contractual context, to generalist courts. For the contextualist, willfully restricting a court's access to the trove of information bearing on the parties' real relationship degrades judicial interpretation and frustrates these parties' efforts to govern their transactions efficiently.[9]

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proach to interpretation. Nine states, joined by the Uniform Commercial Code for sales cases and the Restatement (Second) of Contracts, have adopted a contextualist or anti-formalist interpretive regime. The remaining states' doctrines are indeterminate. *See* Robert E. Scott, State-by-State Survey (unpublished manuscript) (Oct. 7, 2009) (on file with author); U.C.C. §§ 2-202, 2-208, 1-205 (2014); RESTATEMENT (SECOND) OF CONTRACTS §§ 200, 209 (1981).

7 *See* Masterson v. Sine, 436 P.2d 561, 564 (Cal. 1968).

8 *See, e.g.*, U.C.C. §§ 2-202(a) cmts. 1(b), 2; 1-303 cmt. 1 ("[T]he meaning of the agreement of the parties is to be determined by the language used by them and by their action, read and interpreted in the light of commercial practices and other surrounding circumstances. The measure and background for interpretation are set by the commercial context, which may explain and supplement even the language of a formal or final writing.").

9 For a sampling of the scholarship supporting this view, see generally STEVEN J. BURTON, ELEMENTS OF CONTRACT INTERPRETATION (2009); Shawn J. Bayern, *Rational Igno-*

And so the debate has continued: either the parties are empowered to write their contracts to create desired incentives and predictable results without courts later assessing whether the words mean what they say at the instance of a disappointed party, or the courts are presumed to have been delegated the task of assessing the parties' real intentions in light of relevant facts that are not in the contract's text. Viewed in this way, the debate is not about the stark choice between text or context but rather about *who decides* the appropriate mix of text and context to use in resolving a dispute over the meaning of the parties' contractual rights and obligations. The problem, however, is that the artificially narrow focus over which of these class prototypes should apply universally has erroneously framed the choice of the best decision maker as either the parties themselves exercising their freedom to contract as they please or a common law court protecting vulnerable parties from erroneously imposed contractual obligations. This is a false choice and thus the debate is inconclusive. In fact, the range of options for allocating decision rights in the world inhabited both by parties designing their contracts and generalist courts interpreting them is much more diverse and variegated—more highly contextualized as it were—than the assumption that the law must choose between ex ante party autonomy and ex post adjudication. Properly conceived, the mix of text and context in the particular case is best chosen by a wide range of interpretive regimes (both public and private)[10] that function as complements to common law adjudication rather than as antagonists.

Our goal in this Article, therefore, is to shift the focus of discussion from the potential generalization of (competing) contractual prototypes to what we call the design space for contracting: various features in the transactional setting that dispose contracting parties to choose a particular regime and a complementary form of adjudication to govern their relation, rather than another. More precisely, we present a typology of these relations sufficiently rich to capture the breadth of current contractual experience but also sufficiently parsimonious to serve as the basis for an understanding of the central rela-

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rance, Rational Closed-Mindedness, and Modern Economic Formalism in Contract Law, 97 CALIF. L. REV. 943 (2009); James W. Bowers, *Murphy's Law and the Elementary Theory of Contract Interpretation: A Response to Schwartz and Scott*, 57 RUTGERS L. REV. 587 (2005); Steven J. Burton, *A Lesson on Some Limits of Economic Analysis: Schwartz and Scott on Contract Interpretation*, 88 IND. L.J. 339 (2013); Juliet P. Kostritsky, *Plain Meaning vs. Broad Interpretation: How the Risk of Opportunism Defeats a Unitary Default Rule for Interpretation*, 96 KY. L.J. 43 (2008).

10 We use the term "interpretive regimes" to refer to the full range of non-adjudicatory systems that regulate the mix of text and context that will govern any particular interpretive dispute. These include private interpretive structures among individual contracting parties, collective bodies such as trade associations, public agencies such as the Federal Trade Commission, and, in some circumstances, general purpose courts.

tionship between the factors that shape the design of any given contract and the role of courts in interpreting that design.

The starting point of our analysis is the recognition that how contracting parties deal with interpretation issues in designing their contracts, and how courts optimally respond to the parties' efforts, depends on two critical characteristics of the particular contracting environment. The first is the level of uncertainty[11]—whether commercial practices are stable and predictable, or disrupted by unforeseeable changes in technical possibilities and market conditions. The second is the scope, thickness, or scale of the market—whether there are many traders or few engaged in a particular class of transaction using similar contracting strategies.[12] All else equal, the higher the level of uncertainty, the more difficult it is for parties to write and courts to interpret complete, state-contingent contracts. Rather, when the level of uncertainty is high, collaborating parties develop interpretive mechanisms based on rich and regular exchange of information on a project's progress that allow each party to ascertain the other's capacity jointly to define and produce a product. All else equal, the greater the number of traders engaged in a transaction, the more likely that the interpretive regime—terms adapted to current need and a mechanism for adjusting terms as needs change—will be provided by a collective entity, such as a trade association, that can provide to a court the necessary context for interpretation.[13]

The interplay of these two forces—uncertainty and scale—draws attention to new forms of contracting among legally sophisticated parties unanticipated in earlier discussions of textualist prototypes, and

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11 It is commonplace to follow Frank Knight and distinguish between risk—the likelihood of an event that can be estimated probabilistically—and uncertainty—the likelihood of whose occurrence, or even whether it could happen at all, that is unknown. FRANK H. KNIGHT, RISK, UNCERTAINTY AND PROFIT 19–20 (1921); *see* Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431, 433 n.2 (2009). For a helpful discussion of how the incomplete foresight associated with Knightian uncertainty is central to institutional (contractual) design, see Rudolf Richter, Efficiency of Institutions: From the Perspective of New Institutional Economics with Emphasis on Knightian Uncertainty 17–21 (July 13, 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=2105604. Also, see *supra* note 120.

12 A thick market is one in which many commercial actors are exchanging goods or services by using the same or similar contracting behaviors and strategies. Hence the contracting is multilateral.

13 In previous work, we have assessed how uncertainty and scale shape how contracting parties deal with a particular manifestation of uncertainty: the design of innovative contracts that respond to changes in the economic environment by changing existing practices to respond to the new circumstances and then stabilize these new arrangements through a variety of institutions. *See* Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Contract and Innovation: The Limited Role of Generalist Courts in the Evolution of Novel Contractual Forms*, 88 N.Y.U. L. REV. 170, 172–74 (2013). In this Article, we generalize the central role of uncertainty and market scale to interpretive issues more broadly.

helps clarify the (often overwhelming) institutional demands that contextualist prototypes place on generalist courts. Most of the commercial contracting practices that have evolved in response to varying levels of uncertainty and scale do not map onto any of the traditional prototypes that have been the foundation of the current disputes between textualists and contextualists.[14] Thus, for example, the design of sophisticated information-exchange regimes to cope with high levels of uncertainty, where parties explore the capacities of their counterparts and the viability of joint projects, in effect abandons the probabilistic world at the foundation of the executory contract and its regime of expectation damages. Here collaboration becomes the *precondition* for determining the probabilities of success, and for this reason expectation of future gain cannot be the measure of breaches of the obligation to collaborate.[15]

The design space for contracting marked out by increasing levels of uncertainty and market thickness highlights new forms of legally sophisticated contracting, but it also recasts the contextualist prototypes as special cases that demand novel institutional responses. Placed in our typology, mass-market contracts with consumers—one of the two traditional prototypes involving legally unsophisticated parties—stands as a special case of contracting in thick markets under low uncertainty. While large and well-endowed sellers either have no need to cooperate with others or can collude with their peers when they do, consumers are fragmented and infrequent buyers of many goods, and must resolve nearly insurmountable collective action problems to secure economies of scale in contracting. Whatever protection the state wishes to provide these isolated and legally unsophisticated parties must occur, therefore, at the initial stage in the form of interpretive limits on the design of consumer contracts. The lessons of scale that have motivated commercial parties to create specialized interpretive regimes argue for a similar response to the regulation of consumer contracts: agencies and courts working in tandem can best assess the fairness and efficiency of non-negotiated contract terms.[16]

Similarly, the second prototype of legally unsophisticated parties—smaller firms such as machine shops supplying numerous firms in various industries with parts produced using the same set of flexible machines—is in our typology a special case that straddles two categories. On the one hand, these sellers engage in repeated dealings in fairly thick markets: the parts are made by the same processes, often to

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14 For a discussion of those prototypes and their respective normative claims, see *infra* Part I.B.

15 *See infra* Part III.B.4.

16 *See infra* Part IV.A.1. The EU's consumer law directives—framework legislation that must be transposed in national law by member states—are the most prominent example. *See infra* note 72 and accompanying text.

similar tolerances, even if the uses vary greatly. But transactions of the same type with the same kind of party are too infrequent and irregular as to warrant investments in creating and updating an industry-wide code with precise contract terms. On the other hand, no single transaction or set of transactions with a single buyer is large enough to warrant investment in legal sophistication and an elaborate, bespoke contract. Hence, legally unsophisticated commercial parties in this betwixt and between situation use standard-form documents; they typically elect to leave their agreements unintegrated and to ignore conflicts between forms proffered by each.[17] The result is an interpretive default that delegates to courts the decision on how best to flesh out unwritten understandings on a case-by-case basis.

But there is virtually no evidence that courts, even those operating under the U.C.C.'s invitation to broadly examine context, actually undertake such empirical investigations, and hence little reason to imagine they could succeed if they did.[18] Long-term, reciprocal relations always reflect the idiosyncrasies of the histories of each party with the others, and these idiosyncrasies prevent the community's practice from settling into a determinate rule.[19] Thus, even if generalist courts were better equipped for empirical investigation than they normally are, there will typically be no custom-based, context-embedded rule for them to discover.[20] Nonetheless, under certain circumstances—most often when judges and parties share a common background, and meet in the resolution of broadly similar cases over many years—courts historically, and in special cases today, have devel-

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17 *See infra* Part IV.B.1.

18 In fact, recent research on the medieval law merchant, the formation of rules regarding commodity exchanges in early twentieth-century trade associations, and the current practices of a closed community of cattle-feed traders, strongly suggest that ongoing, "traditional" dealings never crystalize into well-defined, customary rules at all. *See* Emily Kadens, *The Myth of the Customary Law Merchant*, 90 TEX. L. REV. 1153, 1176–77 (2012); Lisa Bernstein, Trade Usage in the Courts: The Flawed Conceptual and Evidentiary Basis of Article 2's Incorporation Strategy 18–21 (Jan. 10, 2014) (unpublished manuscript) [hereinafter Bernstein, Trade Usage in the Courts], *available at* http://ssrn.com/abstract=2366533 (analyzing empirical evidence showing courts typically rely on unreliable evidence to establish usages); Lisa Bernstein, *Merchant Law in a Modern Economy* 9–12 (Univ. of Chi. Law Sch. Coase-Sandor Inst. for Law & Econ. Research, Paper No. 639, 2013) [hereinafter Bernstein, *Merchant Law in a Modern Economy*], *available at* http://ssrn.com/abstract=2242490. This evidence suggests that many courts, lacking expertise, fall back instead on interested party testimony and generic concepts of reasonable commercial behavior rather than a careful evaluation of complex evidentiary submissions. The lack of any systematic inquiry into actual practices may also reflect the fact that any context evidence that is introduced must be evaluated in an environment of extreme moral hazard where one party who is disappointed by fate seeks to persuade the court to shift the relevant risk to the counterparty. *See infra* notes 141–44 and accompanying text.

19 *See* PIERRE BOURDIEU, OUTLINE OF A THEORY OF PRACTICE (Richard Nice trans., 1977).

20 *See* Richard Craswell, *Do Trade Customs Exist?*, *in* THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW 118–48 (Jody S. Kraus & Steven D. Walt eds., 2000).

oped expertise in particular domains of commerce, and by entering the parties' epistemic community can create an interpretive regime that effectively accommodates ex post review of their practices.[21]

The only one of the traditional prototypes that does, in contrast, fit securely in our typology concerns commercial transactions in thin markets at medium levels of uncertainty. In this case, legally sophisticated parties act in conformity with textualist expectations: they specify ex ante, in bespoke contracts, the mix of text and context a generalist court should apply in its after-the-fact determination of their respective obligations, and they rely on adherence to their instructions.[22] But increase the level of uncertainty and the contract becomes an interpretive framework that limits the court to sanctioning defections from broad, mutual commitments to collaborate.[23] Decrease, perhaps only slightly, the level of uncertainty, and increase the number of transactors, and the contract becomes a collection of precise terms, defined and frequently updated by a trade association, and disputes arising under it are likely to be resolved by a specialized, arbitral body.[24]

More generally, our typology of the different interpretive regimes that choose between text and context not only strips the traditional contractual prototypes of general significance, but shows that generalist courts are, and under current conditions should be, less central to adjudication of contract disputes than assumed by both sides in the ongoing debate. Our analysis strongly suggests that courts need to acknowledge in doctrine, and contract scholars must acknowledge in theory, what commercial parties have long recognized in practice: generalist judges applying general, mandatory legal doctrine cannot effectively determine the environments in which context matters.[25] The evolution of the history of contract doctrine shows that the common law has lost the general capacity to successfully combine text and context through the adjudicatory process as a substitute for a regime of contract design.[26] In contrast to early courts of equity, where the courts were close to the actors in a largely homogenous economy, generalist courts today are removed from the enormously varied commercial contracting context in modern economies and therefore critically impaired in their ability to divine how and when parties would braid both text and context in their contracts. Given the variety of situations, the limits of the generalist judiciary, and the doctrinal

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21 *See infra* Part IV.B.

22 *See infra* Part III.B.2–3.

23 *See infra* Part III.B.4.

24 *See infra* Part III.C.1.

25 *See generally* Bernstein, Trade Usage in the Courts, *supra* note 18; Bernstein, *Merchant Law in a Modern Economy*, *supra* note 18, at 11–12.

26 *See infra* Part II.

logjam courts have created, it is perhaps unsurprising that sophisticated commercial parties turn to specialized interpretive regimes to accommodate text and context and to resolve their disputes reliably at acceptable cost.[27]

The Article proceeds as follows. In Part I we survey in more detail the existing landscape of contract interpretation doctrine and scholarship. Here we show how and why the current debate came to be framed as a contest among proponents of contrasting contractual prototypes, each represented as of nearly universal significance. We argue that the focus on the traditional text versus context prototypes masks the way that differences in levels of uncertainty and scale shape contemporary contracting practices.

In Part II we address history to show that generalist courts in preindustrial England, in contrast to today, were capable of supporting the two contract functions at odds in current doctrinal disputes—adhering to ex ante rules and updating those rules over time by combining text with context—especially when the two functions were divided between law and equity. With the merger of law and equity and the embodiment of the merged doctrine in the prototype of the executory contract, the difficulty of such "unified" and universally applicable modes of interpretation became apparent.

In Part III we focus on the critical roles of uncertainty and scale in determining how legally sophisticated parties, both individually and collectively, create interpretive regimes that determine the mix of text and context in commercial contracting. Here we generally endorse the textualist claim that these commercial parties are better able than generalist courts to decide how best to take context into account in different environments, but we qualify that assertion by specifying the various situations in which the resulting interpretive arrangement deviates from the classical image of the bargained-for, state-contingent contract.

Finally, in Part IV we focus on the unique issues raised when legally unsophisticated parties contract. With respect to consumer transactions, we address the analytic and policy confusion that has resulted from courts deploying general contract principles to address the problems of consumer protection. We argue that deterring rent-seeking and exploitation requires an interpretive regime such as that in the European Union that authorizes protection of certain interests in particular domains and prohibits practices antithetical to those interests and an orderly market generally. With respect to legally unsophisticated commercial parties, we then show that the core problem is the assumption that generalist courts are capable of both divining un-

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27 *See generally* Gilson, Sabel & Scott, *supra* note 11.

derlying custom and practice and applying that knowledge to the case at hand. We argue that the institutional knowledge that developed in traditional courts of equity can be replicated if courts can acquire an expertise in the relevant transactional prototypes. However, legally unsophisticated commercial parties who rely on generalist courts to unpack context are subject to a measurably higher risk of judicial error: these parties inevitably trade off lower front-end contracting costs for higher enforcement costs on the back end.

I
Reframing the Divide Between Text and Context in Contract Interpretation

A. The Contrasting Purposes of Contract Interpretation: Ex Ante Contract Design Versus Ex Post Adjudication[28]

As we noted above, interpretation disputes are the largest single source of commercial contract litigation.[29] But despite the importance of having consistent, predictable, and efficient rules of interpretation, how to interpret contracts is the least settled question in contemporary contract doctrine and scholarship.[30] This is in large part because modern contract law is assumed to be unitary—that is, a single set of legal rules and governing policies presumably applies to all agreements regardless of the status of the contracting parties. Thus, debate continues, fruitlessly, about the respective advantages and disadvantages of textualist and contextualist theories of interpretation, while the larger issues of who can best decide when and to what extent context should supplement text in interpreting a particular contract, and hence how and by whom interpretive regimes should be designed, are ignored.

Conceptually, "[t]extualist theories undergird the formal common law doctrines of contractual interpretation, such as the parol evidence and plain meaning rules."[31] Both doctrines are designed to give parties some control over the process courts will use to interpret their contracts; in effect, the parties are given leeway to design their contract by specifying whether and to what extent a court will consider evidence contrary to the contract's language.[32] This interpretive

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28 The discussion in this Part draws on Robert E. Scott, *Text Versus Context: The Failure of the Unitary Law of Contract Interpretation*, *in* The American Illness: Essays on the Rule of Law 312 (Frank H. Buckley ed., 2013).

29 *See supra* notes 1–2 and accompanying text.

30 *Id.*

31 Scott, *supra* note 28, at 312.

32 The parol evidence rule enables parties to control the admissibility of certain kinds of evidence in any future adjudication of disputes over their agreement. When parties choose to fully integrate or commit to writing the entirety of an agreement (and declare that they have done so in a merger or integration clause), they forfeit the right in subse-

approach, followed by a substantial majority of common law courts,[33] privileges integrated contracts over context evidence that arguably suggests the agreement contained additional or different terms or meanings. Textualist jurisdictions, such as New York, use a "hard" parol evidence rule that gives presumptively conclusive effect to merger or integration clauses and, in their absence, presume that the contract is fully integrated if it appears final and complete on its face.[34] In the same spirit, the textualist approach bars context evidence suggesting that parties intended to impart nonstandard meaning to language that, read alone, is unambiguous.[35] From the textualist perspective, therefore, the parol evidence and plain meaning rules are tools with which the contracting parties can control the evidence courts will use

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quent litigation to prove understandings they declined to include in their integrated writing or that, they claim, emerged in the course of performance of the agreement. The common law thus treats the decision to integrate an agreement as a matter of party discretion.

Similarly, the best understanding of the plain meaning rule treats it as a device for preserving a reservoir of terms with clear meanings that cannot be contradicted in adjudication by contextual evidence supporting a different meaning. On this account, the plain meaning rule makes available a public fund of terms with judicially protected meanings on which contractual parties can rely to effectively communicate their commitments to each other and to courts. Jody S. Kraus & Robert E. Scott, *Contract Design and the Structure of Contractual Intent*, 84 N.Y.U. L. Rev. 1023, 1046–48 (2009).

[33] A large majority of U.S. courts continue to follow the traditional, textualist approach to contract interpretation. *See supra* note 6.

[34] *See, e.g.*, Morgan Stanley High Yield Sec., Inc. v. Seven Circle Gaming Corp., 269 F. Supp. 2d 206, 213–15 (S.D.N.Y. 2003) (holding that the prior agreement is excluded where the writing appears to embody a final agreement in view of thoroughness and specificity); Intershoe, Inc. v. Bankers Trust Co., 571 N.E.2d 641, 643–45 (N.Y. 1991) (same); Mitchill v. Lath, 160 N.E. 646, 646–48 (N.Y. 1928) (upholding the presumption and excluding evidence of collateral agreement to land sale contract). In addition, merger clauses are given virtually conclusive effect in New York. *See* Tempo Shain Corp. v. Bertek, Inc., 120 F.3d 16, 21 (2d Cir. 1997) ("Ordinarily, a merger clause provision indicates that the subject agreement is completely integrated, and parol evidence is precluded from altering or interpreting the agreement."); Norman Bobrow & Co. v. Loft Realty Co., 577 N.Y.S.2d 36, 36 (App. Div. 1991) ("Parol evidence is not admissible to vary the terms of a written contract containing a merger clause.").

[35] The plain meaning rule addresses the question of what legal meaning should be attributed to the contract terms that the parol evidence rule has identified:

> Contests over the meaning of contract terms thus follow a predictable pattern: one party claims that the words in a disputed term should be given their standard dictionary meaning, as read in light of the contract as a whole, the pleadings, and so forth. The counterparty argues either that the contract term in question is ambiguous and extrinsic evidence will resolve the ambiguity, or that extrinsic evidence will show that the parties intended the words to be given a specialized or idiosyncratic meaning that varies from the meaning in the standard language. As with the division over hard and soft parol evidence rules, courts have divided on the question whether express contract terms should be given a 'contextual' or a 'plain meaning' interpretation. Under the latter practice, when words or phrases appear to be unambiguous, extrinsic evidence of a possible contrary meaning is inadmissible.

Schwartz & Scott, *supra* note 4, at 962.

to interpret the portion of their agreement that they intend to make legally enforceable.

This straightforward account of the textualist interpretation doctrines as tools for contract design used by autonomous parties entering into voluntary, bargained-for agreements is relatively uncontroversial. But courts sometimes face a dilemma: maintain fidelity to the language and purpose of the various textualist doctrines even when the outcome apparently thwarts the parties' intentions as understood ex post, or maintain fidelity to the parties' apparent intentions even though this requires the consideration of contextual evidence that textualist interpretation otherwise would exclude.

Contextualist courts resolve this dilemma by deploying their equitable powers to avoid the application of formal contract doctrine that yields an apparently unfair or erroneous result. Thus, in jurisdictions following the lead of the Second Restatement of Contracts[36] and in all contracts governed by the U.C.C.,[37] contextualist theories advocate a two-stage interpretive regime. Under this regime, interpretive doctrines such as the parol evidence rule are treated merely as prima facie guidance, which courts can (and should) override by considering additional evidence of the context of the transaction if they believe that doing so is necessary to substantially "correct" or complete the parties' written contract by realigning it with its "true" meaning. This ex post judicial determination of the contractual obligation serves as a fallback mechanism whenever a court determines that interpreting contract terms according to the parties' apparent written instructions will fail to achieve the parties' purposes. Under the contextualist view, every contract comes with a judicial insurance policy permitting the replacement or enrichment of contract terms that, viewed in what the court believes to be the proper context, have ill-served the parties' intentions.[38]

Contextualists argue, therefore, that formal interpretive rules that exclude certain categories of extrinsic evidence deprive the factfinder of indispensible information relevant to deciding the case and thus can distort the court's assessment of what the parties meant by their agreement. Contextualist jurisdictions, such as California, carry this view to its logical limit and reject the notion that words in a contract can have a plain or unambiguous—context free—meaning at all. By the same logic they favor a soft parol evidence rule. Here the

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36 *See generally* RESTATEMENT (SECOND) OF CONTRACTS §§ 210 cmt. b; 212 cmt. b; 214 (1981).

37 *See generally* U.C.C. §§ 2-202 cmts. 1(b), 2; 1-303 cmt. 1 (2014). Article 2 of the Uniform Commercial Code, adopted in all states except Louisiana, governs all "transactions in goods." U.C.C. § 2-102.

38 *See* Kraus & Scott, *supra* note 32, at 1025.

test for integration admits extrinsic evidence notwithstanding an unambiguous merger clause declaring the contract to be an integrated writing or, absent such a clause, notwithstanding the fact that the writing appears final and complete on its face.[39] Courts in these jurisdictions "regard a merger clause as raising only a rebuttable presumption of integration, one that is subject to being overridden by extrinsic evidence that the parties lacked any such intent."[40]

The debate between contextualism and textualism is intense precisely because there is a normative justification for each of the traditional prototypes that have been used as exemplars for each approach. In Part I.B, we set out the foil for our argument by describing these distinct justifications. Part I.C then argues that the prototypical contractual transactions that drive the debate obscure the diversity of circumstances that contracting parties confront in practice. By focusing on these different circumstances we can see how the key factors that influence contract design shape the interpretive regimes that integrate both text and context.

B. Dueling Justifications

1. *The Justification for Contextualism*

Under autonomy theories of contract, the parties' agreement has normative force because the parties actually agreed to it.[41] Thus, the law's task is to enforce the parties' will—their freedom to contract—to better permit realization of their goals. These theories of contract require courts to find out, as far as is possible, what the parties meant by the words they used.[42] A contextualist approach to interpretation ap-

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39 *See, e.g.*, Pac. Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co., 442 P.2d 641, 645 (Cal. 1968) ("[R]ational interpretation requires at least a preliminary consideration of all credible evidence offered to prove the intention of the parties."); Masterson v. Sine, 436 P.2d 561, 564 (Cal. 1968) (admitting parol evidence to vary terms of deed on ground that "[e]vidence of oral collateral agreements should be excluded only when the fact finder is likely to be misled"); *see also* Int'l Milling Co. v. Hachmeister, Inc., 110 A.2d 186, 190–92 (Pa. 1955) (finding extrinsic evidence of negotiations and antecedent agreements admissible to show buyer had not assented to the contract as a complete integration of the contract despite the presence of an express merger clause); 3 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 578 (1960) ("The fact that a written document contains one of these express provisions does not prove that the document itself was ever assented to or ever became operative as a contract. Neither does it exclude evidence that the document was not in fact assented to and therefore never became operative.").

40 Scott, *supra* note 28, at 316.

41 Most autonomy-based theories are premised on either a notion of consent or the exercise of will, such as the making of a promise. For discussion, see ROBERT E. SCOTT & JODY S. KRAUS, CONTRACT LAW AND THEORY 23–26 (5th ed. 2013); CHARLES FRIED, CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION 13–16 (1981); Jody S. Kraus, *Philosophy of Contract Law*, *in* THE OXFORD HANDBOOK OF JURISPRUDENCE AND PHILOSOPHY OF LAW 18 (Jules Coleman & Scott Shapiro eds., 2002).

42 It is universally understood that a court's role in interpreting a contract is to determine the intentions of the parties. Intent, in turn, is determined objectively and prospec-

pears to follow logically from this freedom of contract premise: it invites courts first to learn about the commercial context and then to interpret express contract terms in light of that context. Implicit in a contextual approach are two key assumptions: (1) that courts have the capability of learning about the commercial context, and (2) that the parties could have and would have completed the contract as the court has done had they been able to do so at reasonable cost.

These two contextualist assumptions derive from quite separate concerns about textualist rules of interpretation. The assumption that courts can accurately recover the context undergirds the "incorporation" approach to standard commercial sales contracts championed by Karl Llewellyn and enshrined in Article 2 of the U.C.C.[43] A separate concern about the risk of fraud and exploitation in transactions with unsophisticated parties animates the second.[44] Contextualist interpretations are often justified as necessary to prevent the exploitation of legally unsophisticated individuals who enter into written contracts with sophisticated parties who supply written contract terms that alter previously settled understandings. As Judge Roger Traynor famously wrote: "[T]he party urging the spoken as against the written word is most often the economic underdog, threatened by severe hardship if the writing is enforced."[45] By examining the context ex post, courts presumably are able to monitor the process by which certain terms were reduced to writing, thereby protecting unsophisticated parties from difficult-to-detect forms of exploitation.

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tively. *See* Hotchkiss v. Nat'l City Bank, 200 F. 287, 293 (S.D.N.Y. 1911) (Hand, J.) ("A contract has, strictly speaking, nothing to do with the personal, or individual, intent of the parties."). In other words, a court is directed to recover the parties' objectively manifested intentions concerning *both* the objectives or "ends" of their agreement *and* the "means" they may have chosen to determine those ends should they later dispute the meaning of the agreement.

43 As noted in text, Llewellyn believed that the law should identify and incorporate the "working rules" or governing norms already being used successfully by the parties themselves. Legal incorporation was necessary in order to tailor the rules to particular practices and trade usages. This notion of incorporation of custom and practice is deeply imbedded in the Code. *See, e.g.*, U.C.C. § 1-303 (2014) (permitting courts to analyze course of performance, course of dealing, and usage of trade, for contract interpretation purposes). Comment 3 of § 1-303 provides that "[usages and customs] furnish the background and give particular meaning to the language used [in the contract], and are the framework of common understanding controlling any general rules of law which hold only when there is no such understanding." In this way, Llewellyn's article 2 explicitly invites incorporation. The invitation to contextualize the contract in this manner was explicitly embodied in the Code's definition of "[a]greement" as "the bargain of the parties in fact, as found in their language or inferred from other circumstances, including course of performance, course of dealing, or usage of trade . . . ." U.C.C. § 1-201(b)(3). For discussion, see Robert E. Scott, *The Rise and Fall of Article 2*, 62 LA. L. REV. 1009, 1037–41 (2002).

44 *See supra* note 7 and accompanying text.

45 Masterson v. Sine, 436 P.2d 561, 564 (Cal. 1968).

In sum, the contextualist approach focuses on contracts between legally unsophisticated parties who enter mass-market, standardized transactions with sophisticated merchants (the consumer context), or commercial contracts embedded in customary norms and terms of trade among legally unsophisticated businessmen (the sales context). Both of these prototypes contradict the textualist presumption of the general availability of bespoke contracts for at least one party in the transactional settings to which they refer. Rather, the contextualist regime rests on the powerful intuition that fair and efficient contracting takes place in a social context, and that parties (and society) would prefer courts to take advantage of hindsight in bringing that context into view in a way that supports the realization of their (legitimate) contractual objectives. In this view, it seems perverse for a court to hold parties to the apparent plain meaning of terms knowing that those parties themselves would have rejected that meaning had they upon formation of the contract known what the court now knows. Holding parties to their formally specified contract terms when those terms no longer (or never did) reflect their shared intent exalts formal doctrine over substance.

Despite the fact that common law courts traditionally have followed a textualist approach, the U.C.C. and the Second Restatement continue to encourage courts to be contextual.[46] Conventional scholarly wisdom has long held that this interpretive approach represents a significant improvement over the formalism of the common law.[47] This is because contextualism is assumed to ascertain the parties' intentions more accurately. More evidence usually is better than less. Particular parties may have intended apparently clear language to be read in a nonstandard way, or acted under the contract in ways neither explicitly directed nor prohibited given the contractual language. Excluding evidence of these parties' prior negotiations or subsequent practices risks interpreting their contracts in opposition to the parties' actual intentions.[48]

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46 *See* U.C.C. §§ 1-205, 2-202, and comments; RESTATEMENT (SECOND) OF CONTRACTS §§ 210, 212, 214 (1981). For discussion, 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, *supra* note 20, at 149–92.

47 *See* JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS (6th ed. 2009); *see also supra* note 41 and accompanying text.

48 Of course, the reverse could be true. The U.C.C. directs courts to construe express terms and extrinsic evidence from practices or usages as consistent with each other. But sometimes the parties may actually have intended that their clear language be read in the standard (plain meaning) way despite the fact that the language itself conflicts with the prior practices and negotiations of the parties. In such a case, a court that relies heavily on context risks misinterpreting the parties' actual intentions.

2. *The Justification for Textualism*

As compelling as it seems, however, the contextualist justification of a two-stage regime of contract interpretation rests on an unsupported central premise: that litigating parties generally want a court "to reinterpret the formal terms of [their] written contract in light of the surrounding context of the transaction so as to better achieve their shared contractual purposes."[49] But there is good reason to doubt that legally sophisticated parties typically, let alone always, prefer this method of interpreting their contracts. Rather than a rule that always subordinates formal contract terms to ex post judicial revision, both theory and available evidence suggest that legally sophisticated parties prefer a regime that follows the parties' instructions specifying when to enforce formal contract terms strictly and when to delegate authority to a court to consider surrounding context evidence.[50]

Textualist arguments accordingly focus on the insight that, for legally sophisticated parties who write bespoke contracts, context is endogenous; the parties can embed as much or as little context into a customized agreement as they wish, and they can do so in many different ways.[51] By eliminating the risk that courts will erroneously infer the parties' preference for any particular contextual interpretation, such a regime reduces the costs of contract enforcement and enhances these parties' control over the content of their contract. That control, in turn, permits legally sophisticated commercial parties to economize on the costs of contracting.

Textualists offer several justifications to support their claims. First, a valuable state function is to create standard vocabularies for the conduct of commercial transactions.[52] When a phrase has a set, easily discoverable meaning, parties who use it will know what the phrase requires of them and what courts will say the phrase requires. By insulating the standard meaning of terms from deviant interpretations, this strategy preserves a valuable collective good, namely a set of

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49 Scott, *supra* note 28, at 314.

50 There is empirical evidence that most commercial parties prefer the freedom to choose how and when to delegate discretion to courts to interpret commercial contracts. *See* Miller, *supra* note 5, at 1478 ("New York's formalistic rules win out over California's contextualist approach. As predicted by theory, sophisticated parties prefer formalistic rules of contract law.").

51 *See infra* Part III.B.

52 *See* Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 NW. U. L. REV. 847, 853–56 (2000) [hereinafter Scott, *The Case for Formalism*]; Alan Schwartz, *Contract Theory and Theories of Contract Regulation*, 92 REVUE D'ECONOMIE INDUSTRIELLE 101, 102–04 (2000); Scott, *supra* note 46, at 157–58.

terms with clear, unambiguous meanings that is already understood by the vast majority of commercial parties.[53]

Second, a textualist theory of interpretation also creates an incentive to draft carefully. Under a contextualist theory, a party for whom a deal has turned out badly has an incentive to claim that the parties meant their contract to have a different meaning than the obvious or standard one. Such a party can often find in the parties' negotiations, in their past practices, and in trade customs, enough evidence to ground a full, costly trial, and thus to force a settlement on terms more favorable than those that the contract, as facially interpreted, would direct.[54] Moreover, this burden of careful drafting does not give untrammeled freedom to parties relying on the written document to exploit mistakes or misunderstandings. Importantly, the textualist interpretive doctrines are not self-executing. They do permit a court (within bounds) to exercise discretion in finding evidence of fraud, mutual mistake, or ambiguity in the formulation of key terms,[55] or even the absence of contractual obligation altogether.[56]

Finally, textualist interpretation permits legally sophisticated commercial parties to economize on contracting costs by shifting costs from the back end of the contracting process (the enforcement function) where a court would inquire broadly into context, to the front end of the contracting process (the negotiating and design function) where the parties specify the extent to which context will count.[57] Parties can do this, for example, by drafting a merger clause that integrates their entire understanding, including relevant context, into the written contract and then having the court apply a plain meaning interpretation to those contract terms that are facially unambiguous. Importantly, when parties fully integrate the agreement and use a merger clause, an interpretation dispute over contract terms may be

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53 *See* Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CALIF. L. REV. 261, 286–88 (1985). For a more philosophical examination of "plain meaning," see SCOTT & KRAUS, *supra* note 41, at 539–42; Scott, *supra* note 28, at 333 n.41.

54 If a party can impeach careful contract drafting with evidence of this type, the rewards to careful contract drafting will fall relative to the costs of such efforts. In consequence, parties will write precise, directive contracts less frequently, and the expected costs of litigation initiated by the party disfavored by the ultimate outcome of the contract will rise, encouraged by the chance that the court will make a mistake. *See* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law,* 113 YALE L.J. 541, 584–90 (2004).

55 For discussion, see SCOTT & KRAUS, *supra* note 41, at 420–37, 539–41, 691–93.

56 *See* Hewlett-Packard Co. v. Oracle Corp., No. 1-11-CV-203163, 2012 WL 7991733, at *27, *32 (Cal. Super. Ct. Aug. 28, 2012) (rejecting Oracle's claim of no contract after considering context evidence and holding Oracle to plain language of the agreement).

57 For a discussion of how contracting parties can economize on total contracting costs by shifting costs between the drafting or front end of the contracting process and the adjudication or back end of the process, see generally Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 YALE L.J. 814 (2006).

resolved on summary judgment, thereby substantially reducing ex post enforcement costs.[58] The reduction in the chance of an expensive trial, in turn, reduces the settlement value of a claim, and therefore the incentive for a disappointed party to pursue opportunistic litigation in the first place.[59]

If instead a court decides to consider additional context evidence, it must necessarily deny a motion for summary judgment and set the case for full trial on the merits. Thus, if litigation cost is considered, there is a strong argument that in cases where uncertainty is low and risks can be allocated in advance, many legally sophisticated commercial parties prefer textualist interpretation so that disputes can be resolved without the punishing costs of a full trial and the skewed incentives that derive from the anticipation of these costs.[60] Such parties will rationally invest in sufficient drafting costs to insure that a court interpreting the written document together with the pleadings and briefs will be able to arrive at the "correct interpretation" more often than not.[61] Here the simple comparison is between the costs of drafting and the costs of a trial.

This description of the two approaches and their key assumptions exposes a deep puzzle: Since the two competing approaches to interpretation are supported by quite different contractual prototypes, why do they engage in debate at all, much less struggle for supremacy? The answer lies in their shared presumption of the unitary nature of contract law and the mandatory nature of interpretation doctrine. For both sides in the interpretation debate, when a court (or legislature) chooses either a textualist or a contextualist approach to interpretation, that choice applies to all transactional prototypes, and particular parties cannot choose ex ante to have their particular contract interpreted according to the disfavored approach. Thus, the ongoing interpretation debate is not only binary—either the parties exercise freedom to contract as they please or a court protects vulner-

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58 *Cf.* Schwartz & Scott, *supra* note 4, at 961 ("A court that uses a soft parol evidence rule is likely to deny a motion for summary judgment, thus increasing the expected litigation costs of both parties.").

59 *See id.* at 947–51.

60 *See id.* at 944–47.

61 This argument is premised on the claim that firms behave as if they are risk neutral. Assume, for example, that there is a distribution of possible judicial interpretations of a particular contract. A risk-neutral party wants the mean of this distribution to be at the correct interpretation—that is, for the court to be right "on average." Thus, risk-neutral firms prefer to limit enforcement costs—say by resolving interpretation disputes by summary judgment—so long as the courts' interpretations are correct on average. It follows that sophisticated parties (i.e., firms) are more reluctant to expend resources to shrink the variance around the correct mean. Conditional on the quality of the court, variance falls as more evidence is introduced. Thus, such parties prefer to limit the evidence that is introduced in litigation. *See* Schwartz & Scott, *supra* note 4, at 930; Schwartz & Scott, *supra* note 54, at 580.

able parties from error—but also winner-take-all—in any particular "jurisdiction" victory is total for one approach or the other.[62] As we will see, however, the two approaches differ importantly in how imperialist is their claim. A textualist approach does not reject context but instead embeds it in contract design—the parties, not the court, choose the extent to which a court can consider context at the enforcement stage. The next section shows the importance of that difference. The two prototypes that define the text versus context debate represent only a small part of the range of circumstances in which issues of interpretation arise.

C. Beyond the Text and Context Prototypes: The Many Faces of Contract and the Central Role of Uncertainty and Scale

This debate has suffered from a fundamental problem: the focus on the traditional contractual prototypes disguises the fact that contemporary contract practice is far more varied and heterogeneous than is conventionally understood either by courts or by most scholarly treatments. The prototypical contractual transactions that have defined the debate do not capture the diversity of circumstances confronting contracting parties and so cannot capture the ways in which the transactional environment influences the "contracting space": the wide range of institutional design choices available for both legally sophisticated and legally unsophisticated parties to address interpretation. Viewed in this larger frame, we can see that the choice of interpretive style is distributed among a range of private and public interpretive regimes lodged in very different institutional structures. These interpretive regimes then function as complements to common law adjudication rather than as antagonists.

The starting point of our analysis is the claim that two critical characteristics of the particular contracting environment—the thickness of the market and the uncertainty associated with it—determine how contracting parties (or other interpretive bodies) deal with interpretation issues in designing their contracts. We show below in Part III that in contracts between legally sophisticated commercial parties these two characteristics—uncertainty and scale—influence contract design in ways that are not captured by either the textualist or contextualist prototypes.[63]

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62 As noted above, the "jurisdictional" divide between textualist and contexualist interpretive styles varies along two dimensions: First, the states themselves divide along textualist and contextualist lines in their interpretation of disputes arising under the common law of contracts. Second, there is a further division within textualist common law states between those disputes that arise under the common law of contracts and those that involve sales transactions governed by the contextualist style of the U.C.C. *See supra* Part I.A.

63 *See infra* Parts III.A, III.B.1.

When markets are thin and the actors few and scattered, legally sophisticated parties design bilateral interpretive structures to govern their relationship. Here the level of uncertainty will determine precisely how the parties respond to the challenges of contract design. When uncertainty is low, legally sophisticated parties in bilateral relationships can turn to bespoke contracting: by integrating the relevant context into a complete, formal agreement they can specify precisely the evidentiary base available to a court while still preserving the court's historic role in policing opportunism.[64] But as uncertainty increases, legally sophisticated parties will resort to an interpretive regime that braids state-contingent rules with general standards that require a context for interpretation, while at the same time guiding the court in what context matters.[65] Finally, when uncertainty is high, bilateral contracting over product specification can break down completely; the problem is that the parties cannot specify the product that will be produced, let alone the price or terms of sale.[66] Rather, in the process of collaboration, the parties develop interpretive mechanisms based on rich and regular exchange of information on a project's progress that allows each gradually to ascertain the other's capacity jointly to define and produce a product.[67] Context thus becomes endogenous: the contract process is designed to create context rather than respond to it. The result is a bilateral contract that specifies not the terms of an exchange but an interpretive framework designed to delegate to a court only the task of sanctioning defections from the commitment to collaborate.[68]

Where markets are thick, economies of scale lead commercial parties toward specialized collective regimes to resolve their disputes or address common risks reliably and at acceptable cost.[69] The greater the number of traders engaged in a transaction, the more likely that the contracting infrastructure will be provided jointly by a trade association as an industry-specific public good. When collective action problems are severe, or when the costs to the public of break-

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64 *See infra* Part III.B.2.

65 *See infra* Part III.B.3.

66 In previous work, we identified what is loosely called "the information revolution" as the exogenous shock that marked the emergence of collaborative contracting in global supply chains, platform production, and project development. Gilson, Sabel & Scott, *supra* note 11, at 441. These novel interpretive structures are used with increasing frequency in the search for new partners who can collaborate on joint investment in the production of information to evaluate whether a project is profitable to pursue. These types of bilateral arrangements typically take the form of preliminary agreements or letters of intent, as they are termed in the context of corporate acquisitions. *See id.* at 437, 457 n.67, 484.

67 *See infra* note 148 and accompanying text.

68 *See* Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377, 1415–16 (2010).

69 *See infra* Part I.C.1–2.

downs in contracting are likely to be high, public interpretive authorities may collaborate with trade associations in providing such goods.[70] In these circumstances, the parties delegate to the collective effort the task of providing the context relevant to a dispute, and the collective itself is legally sophisticated. When uncertainty is low the chief goal is to render insider understanding in terms that can be incorporated into everyday contracting, establish specialized methods for the expeditious resolution of disputes arising under these contracts, and institutionalize a process for updating terms and forms of dispute resolution in response to developments. When uncertainty is high the chief problem is not establishing the terms of bilateral exchange but rather developing protocols that protect buyers and sellers against hazards that could catastrophically affect them all, and that can only be mitigated by joint efforts, as in the threat of contamination in the commercial food chain.[71]

Contracts involving legally unsophisticated parties are equally influenced by uncertainty and scale but in ways that argue for special treatment. In the case of consumers, for example, mass markets are thick in our typology by definition. However, consumers must resolve nearly insurmountable collective action problems to secure economies of scale in contracting; the promise of scale and its realization are separated by the friction of coordination. The lessons of scale that have stimulated commercial parties to create specialized interpretive regimes argue for a similar response to consumer contracts: regulation can overcome the coordination costs to create interpretive regimes for consumer contracting that parallel those designed by legally sophisticated commercial parties to capture scale economies. In consumer law the EU provides the most prominent example of this type of regime: framework legislation cabins consumer contracts from commercial transactions and blacklists practices regarded as intrinsically unfair to the less sophisticated party.[72]

Similarly, the design choices of legally unsophisticated commercial parties are also influenced by scale and uncertainty but in ways that, absent exceptional institutional settings, are unlikely to optimize contracting costs. The merchant sellers and buyers of goods that are the archetype of this category engage in repeated dealings in fairly

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70 *See* Charles F. Sabel & William H. Simon, *Contextualizing Regimes: Institutionalization as a Response to the Limits of Interpretation and Policy Engineering*, 110 MICH. L. REV. 1265, 1276–78 (2012) (discussing the U.S. Department of Agriculture's regime under the Perishable Agricultural Commodities Act).

71 *See supra* notes 66–68 and accompanying text.

72 The role of courts in this regime is limited but critically important: courts eliminate procedural obstacles to the vindication of these consumer rights and ensure that opportunistic consumers do not game their protections to exploit traders. *See infra* notes 188–95 and accompanying text.

thick markets. But transactions of the same type with the same kind of party are insufficiently frequent and regular to justify investments in creating and updating an industry code with precise contract terms. Yet, neither are these parties able to bear the costs of writing elaborate bespoke contracts for individual transactions that we observe for larger transactions in the absence of scale. Hence, legally unsophisticated commercial parties use standard-form, prefabricated designs in the form of invoices, purchase orders, and acknowledgment documents. In Part IV.B we argue that the result of these constraints is to assign the decision-making role by default to generalist courts that are expected to be contextualist. The dilemma is that courts are asked to determine the operative customs and practices in a dynamic environment in which this task is, quite literally, impossible to perform successfully. Only in a few exceptional instances where concentrations of similar cases create an expert judiciary do we see the emergence of an interpretive regime capable of fulfilling the role historically assigned to the courts of equity at common law.

In the discussion that follows, we develop this taxonomy in greater detail. But first we turn to history to explore how the emergence of the two polar interpretive regimes from the common law made the debate between them—in hindsight limited and even misleading—long seem ineluctable.

II
The Sources of Contract Interpretation

The preceding discussion underscores a fundamental normative premise of the contextualist approach to interpretation: generalist courts, with the benefit of hindsight, are able to determine the context necessary to correctly interpret contracts. In this Part, we argue that the claim of generalist competence was serviceably true under historical circumstances that no longer prevail: the early courts of equity were effectively able to contextualize contracts because they functioned within highly structured communities of which they were an integral part, and were thus likely to be knowledgeable about the context surrounding any interpretive dispute that came before them. In effect, fifteenth-century courts of equity were specialized in the narrow range of activities with which they were presented. In contrast, contemporary courts are operating in a heterogeneous and rapidly changing economy, of which their institutional position affords little detailed knowledge or experience.

Historically, the English common law applied two different sets of doctrines to interpret a disputed contract.[73] The first consisted of

[73] The discussion in this Part draws on Kraus & Scott, *supra* note 32, at 1035–45.

rules—such as the parol evidence and plain meaning rules—cast in objective terms that minimized the need for subjective judgment in their application. They were administered strictly, without exceptions for cases in which the application of a rule appeared to defeat its purpose. These doctrines originated in the first seven centuries of adjudication in King's Bench and Common Pleas, the English courts that produced the corpus of the common law from the twelfth- to the nineteenth century.[74] The second set of doctrines consisted largely of equitable principles originating in the English Court of Chancery, which, by the end of the fourteenth century, began to exercise overlapping jurisdiction with the common law courts to hear cases "where the ordinary course of law failed to provide justice."[75] These doctrines were framed as broad principles administered loosely and were designed to provide exceptions to the common law interpretive rules. They were generally cast in subjective terms and therefore required judges to exercise such judgment by evaluating the context of the particular transaction.[76]

A. The Contrasting Approaches of Law and Equity

The chancery provided an independent and alternative forum as a response both to the procedural constraints imposed on the common law courts, and to the strict, rule-bound inclination of common law judges to apply the common law rigorously without reference to the context of the case.[77] In short, the common law courts provided

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74 J.H. BAKER, AN INTRODUCTION TO ENGLISH LEGAL HISTORY 12–14 (4th ed. 2002).

75 *Id.* at 117.

76 From their inception, the King's Bench and Common Pleas Courts entertained actions only by plaintiffs who purchased an original royal writ, which specified the type of claim that the plaintiff was authorized to bring and the kind of relief to which the plaintiff would be entitled should he prevail. *Id.* at 54. The forms of action authorized in the writs thus defined the content of judicially cognizable rights. If parties had complaints that did not fit within the confines of existing forms of action, they could petition the king himself. Even though the King's Bench and Common Pleas Courts were created by statute, the king retained authority to hear cases in which he believed the common law was "deficient." The king "retained an overriding residuary power to administer justice outside the regular system; but the important limitation imposed on that power by the due-process legislation was that it could be invoked only where the common law was deficient, and never in matters of life, limb or property." *Id.* at 98. In exceptional cases, the king took action by granting a remedy as of grace. As these "exceptional" private suits became more common, they were referred to the king's council. Later, parties addressed their bills directly to the chancellor, who, under the authority of the council, took responsibility for assigning them to appropriate courts for resolution. The chancery always had the power to create a new writ that would provide a form of action suitable to a plaintiff's complaint. But when the plaintiff's claim was based on idiosyncratic facts rendering existing forms inadequate, rather than a common complaint for which no form of action existed, the chancery sought an ad hoc or "contextual" solution rather than the creation of a new form of action. *Id.* at 101–02.

77 *See id.* at 101–03 (explaining that chancery operated "a court of conscience" that was free from the rigid procedures of common law courts).

justice wholesale: common law judges "preferred to suffer hardship in individual cases than to make exceptions to clear rules."[78] In this sense, the common law understood its doctrines as devices for *prospective regulation*: as long as its rules were known in advance and the costs of complying with them were reasonable, its doctrines should be based on their long-term, prospective benefits, not their impact on parties to an individual case at the time of adjudication.[79]

In contrast, "the chancellor's eyes were not covered by the blinkers of [the rules], and he could go into all the facts to the extent that the available evidence permitted."[80] The chancery's sole focus was on just and fair dispute resolution: its concern in interpretive disputes was with the equities of the case at bar, not the prospective effects of a ruling. Indeed, for many years the chancery's decrees had no formal precedential effect,[81] which initially freed the chancery from any concern that its contextualized rulings could undermine the consistency and predictability of adjudication. Moreover, in pre-industrial England the chancery was more intimately familiar with the contextual environment of typical party disputes and could fairly sort relevant from irrelevant facts. Thus, even though the chancery reversed or avoided outcomes dictated by the formal interpretive rules,[82] these actions could be seen as necessary in order to vindicate, rather than undermine, the common law.[83]

Fundamentally, however, the institutions of the common law and the chancery were at cross-purposes. The common law viewed the adjudication of cases primarily as a means of creating and sustaining a

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78 *Id.* at 102.

79 The ex ante approach of the common law courts was summarized in *Waberly v. Cockerel*. "[I]t is better to suffer a mischief to one man than an inconvenience to many, which would subvert a law: for if matter in writing may be so easily defeated, and avoided by such surmise and naked breath, a matter in writing would be of no greater authority than a matter of fact." (1542) 73 Eng. Rep. 112, 113 (K.B.); *see also* BAKER, *supra* note 74, at 325.

80 BAKER, *supra* note 74, at 104. In its earliest incarnation, the procedure in chancery was the antithesis of the procedure in common law courts: no writ was necessary, multiple issues could be joined, evidence was taken free of formal rules, decisions were made by a chancellor rather than a jury, the court was always open, and trials could take place anywhere (including the chancellor's home). *Id.* at 103–04.

81 "In Chancery each case turned on its own facts, and the chancellor did not interfere with the general rules observed in courts of law. The decrees operated *in personam*; they were binding on the parties in the cause, but were not judgments of record binding anyone else." *Id.* at 104. "So long as chancellors were seen as providing ad hoc remedies in individual cases, there was no question of their jurisdiction bringing about legal change or making law." *Id.* at 202.

82 "In Chancery the just remedy was provided not by changing the law but by avoiding its effect in the special circumstances of particular cases." *Id.*

83 Councilors and chancellors viewed themselves as "reinforcing the law by making sure that justice was done in cases where shortcomings in the regular procedure, or human failings, were hindering its attainment by due process. They came not to destroy the law, but to fulfil it." *Id.* at 102.

system of rules justified by their effects over time.[84] In contrast, the chancery viewed the adjudication of cases as an end in itself, in which the sole objective was to do justice between the parties.[85] The result was two competing systems, often with incompatible procedural and substantive doctrines, yet overlapping in jurisdiction.[86]

B. Text Versus Context: The Legal and Equitable Roots of American Contract Law

The system of equitable principles created by the chancery has left an indelible impression on the contemporary common law of the United States. Historically, the division between the common law courts and the Court of Chancery acted as a barrier between the two incompatible regimes. But in the nineteenth century, the chancery was eliminated, and law and equity were merged in both England and the United States.[87] The result was an uncomfortable combination of legal and equitable doctrines; and it was this awkward amalgam that formed the matrix of American contract law.

To this day, therefore, American contract law is torn between the prospective interpretive perspective of common law rules and the retrospective dispute-resolution perspective of equitable doctrines.[88] This tension is embodied in the rules governing the interpretation of contracts. The contract interpretation doctrines originating in the English common law courts included the fundamental protections of textualism, the plain meaning[89] and parol evidence[90] rules. But along with these rules, American contract law also absorbed doctrines originally developed in the chancery "to mitigate the rigours of the Common law."[91] These included equitable doctrines specifically inviting the court to rely on the factual context of the particular dispute in

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84 *Id.* at 13 (explaining that the common law system employed the position that "over and above everything stand the pleas of the royal court, which preserves the use and custom of its law at all times and in all places and with constant uniformity" (internal quotation marks omitted)).

85 *Id.* at 104.

86 *See id.* at 102–03.

87 Ironically, by the nineteenth century, the chancery had developed a set of procedures more arcane and burdensome than the common law procedures it originally sought to mitigate. The resulting administrative delay, combined with corruption born of the chancery's practice of paying clerks on a fee basis rather than salary, ultimately led to the chancery's demise. Soon thereafter law and equity were merged. *Id.* at 111–12, 114.

88 For an example of the continued tension between law and equity in an integrated judicial system, see *infra* notes 240–49 and accompanying text (describing the continuing tension between the Delaware Court of Chancery and the Delaware Supreme Court).

89 The common law applied "to documents a rule of construction that the words had to be given their ordinary meaning." BAKER, *supra* note 74, at 226.

90 *See id.* at 324–25.

91 DAVID J. IBBETSON, A HISTORICAL INTRODUCTION TO THE LAW OF OBLIGATIONS 203 (1999). In general, equity evolved contract doctrines designed to provide far broader protection against perceived fraud than the common law provided. In particular, the core

derogation of the common law rules of interpretation.[92] Conflicts are inevitable among doctrines that require courts to be both generalists and specialists in resolving disputes across a heterogeneous contracting population. Thus, the text versus context tension is baked into the merger of law and equity.

The struggle between the common law rules of interpretation and the equitable exceptions to those rules was rationalized, at least formally, by Samuel Williston, the author of one of the great twentieth-century treatises, into a purportedly coherent set of general rules (and exceptions) that could be applied predictably by common law courts.[93] Willistonian formalism rested on several basic claims: that contract terms could be interpreted according to their ordinary meaning, and that written terms have priority over unwritten expressions of agreement.[94] Williston viewed merger clauses as presumptively establishing a total integration of the agreement sufficient to exclude extrinsic evidence.[95] In the absence of a merger clause, he argued that if the writing appeared to be a complete instrument, it should be found to be a total integration unless additional terms offered by the counterparty were those that might naturally be included in a separate agreement covering those terms.[96] These views on parol evidence had a significant influence on the doctrines adopted by many state courts as they decided interpretation disputes, and Williston's formalist approach to interpretation was subsequently enshrined in the First Restatement of Contracts.[97]

But the tensions between law and equity persisted just beneath the surface of the newly unified law of contract. They were elevated to prominence by the legal realists under the leadership of Arthur Corbin and Karl Llewellyn. Corbin advanced the view that the Willistonian rules governing interpretation were legal fictions and that, properly understood, *all* interpretation issues were context specific.[98]

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equitable contract doctrines provided relief where an agreement was not fully voluntary or informed. *See id.* at 208.

92 *See, e.g.*, WILLIAM STORY, COMMENTARIES ON EQUITY JURISPRUDENCE §§ 153–57 (W.E. Grigsby ed., 1884) (describing the equitable exceptions to the parol evidence rule).

93 4 WILLISTON ON CONTRACTS § 631 (3d ed. 1961) ("[The parol evidence] rule requires, in the absence of fraud, duress, mutual mistake, or something of the kind, the exclusion of extrinsic evidence, oral or written, where the parties have reduced their agreement to an integrated writing."). For discussion, see Dennis M. Patterson, *Good Faith, Lender Liability, and Discretionary Acceleration: Of Llewellyn, Wittgenstein, and the Uniform Commercial Code*, 68 TEX. L. REV. 169, 186–88 (1990).

94 *See* Patterson, *supra* note 93, at 186–88.

95 11 WILLISTON ON CONTRACTS § 33:3. For discussion, see PERILLO, *supra* note 47, at 115–16.

96 11 WILLISTON ON CONTRACTS § 33:25.

97 RESTATEMENT OF THE LAW OF CONTRACTS § 240 (1932).

98 *See* Arthur L. Corbin, *The Interpretation of Words and the Parol Evidence Rule*, 50 CORNELL L.Q. 161, 188–90 (1965).

In his view, courts did (and should) apply rules tactically in order to pursue overarching policy—metaprinciples of fairness and natural justice. In the case of an interpretation dispute, the just result was to determine the actual intention of the contracting parties.[99] According to Corbin, in order to properly capture this intent, all relevant evidence should be considered on any interpretive issue.[100] Procedurally this meant the very evidence whose admissibility was being challenged would be admissible on the issue of whether or not the parties intended the writing to be a total integration. Indeed, Corbin argued, this result was unavoidable: the very judgment as to whether particular contract language was sufficiently unambiguous as to exclude consideration of extrinsic evidence required consideration of just that evidence.[101] Corbin's approach severely undercut the application of the traditional parol evidence and plain meaning rules. Adjudication, he believed, could not reach a fair result unless the court considered the context of the transaction.[102]

Llewellyn advocated a similar commitment to context, although he located the metaprinciple that courts must apply in the common "working rules" found in the practices of commercial parties.[103] The course of prior dealings between the parties, together with the usages in the trade, formed the implicit background for the explicit contracts between merchants practicing within any particular commercial community. Moreover, the actual course of performance under the agreement was the best evidence of the meaning the parties attached to their written contract.[104] But since the working rules arose from custom and practice their jurisdiction was uncertain: they needed the imprimatur of the state. Legal incorporation was necessary, therefore, in order to tailor the rules to particular practices and to resolve the troublesome cases where the relevant norms were in dispute.[105]

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99 6 CORBIN, *supra* note 39, § 577 (1951).

100 *See* Corbin, *supra* note 98, at 188–90.

101 6 CORBIN, *supra* note 39, § 582.

102 Corbin's view was that even if a contract was an unambiguous integration, all relevant extrinsic evidence should be admissible on the issue of the meaning of the agreement, including the evidence of the parties' subjective intentions. *See* 5 CORBIN, *supra* note 39, §§ 24.7–24.9 (Kniffin 1998); Corbin, *supra* note 98, at 162, 188–90.

103 Llewellyn was committed to the idea of filling contractual gaps with default terms that mimicked the arrangement most (or at least many) commercial parties would have made for themselves. In his mind, the solution to the dilemma of the poor fit between overly broad legal default rules and complex commercial relationships seemed straightforward. Rather than use abstract, general standards to regulate these relationships, the law should simply identify and incorporate the "working rules" already being used successfully by the parties themselves. *See* Scott, *supra* note 43, at 1023–24.

104 *See e.g.*, U.C.C. § 2-208 cmt. 1 (2014) ("The parties themselves know best what they have meant by their words of agreement and their action under that agreement is the best indication of what that meaning was.").

105 Scott, *supra* note 43, at 1023–24; ROBERT E. SCOTT & GEORGE G. TRIANTIS, FOUNDATIONS OF COMMERCIAL LAW 15 (2010).

This notion of incorporation of custom and practice was deeply imbedded in article 2 of the Uniform Commercial Code, of which Llewellyn was the principal drafter. Here, "Llewellyn addressed the incorporation objective by reversing the [Willistonian] presumption that the parties' writings . . . [were] the definitive elements of the agreement."[106] Rather, the Code invited contextualization by defining an agreement as "the bargain of the parties in fact, as found in their language or inferred from other circumstances, including course of performance, course of dealing, or usage of trade . . . ."[107] In addition, the new parol evidence rule under the Code admitted inferences from trade usage even where the express terms of the contract seemed perfectly clear and were apparently "integrated."[108]

Unlike Corbin, however, Llewellyn believed that customary practice had only an epistemological and not also a normative relevance.[109] Indeed his reservations about generalist courts were similar to our own,[110] and he was thus unwilling to rely solely on their intuitions to undertake what was essentially an empirical inquiry. Since Llewellyn's purpose was to incorporate the actual context that commercial parties had developed through their practices, he needed a mechanism by which these local norms could be identified by courts. In his mind, that mechanism was the merchant tribunal, made up of a panel of experts that would find specific facts—such as whether the behavior of a contracting party was "commercially reasonable" in the context of the particular dispute.[111] Unfortunately, the idea of the merchant tribunal was too radical for the commercial lawyers who dominated the U.C.C. drafting process.[112] Ultimately, Llewellyn abandoned this key device for discovering the relevant context, while still retaining the architecture of incorporation.[113] As many have suggested, eliminating the merchant jury while retaining the pervasive

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106 Scott, *supra* note 43, at 1038.

107 U.C.C. § 1-201(3) (2014).

108 *See* U.C.C. § 2-202 cmts. 1–2.

109 *See* Alan Schwartz, *Karl Llewellyn and the Origins of Contract Theory*, *in* THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW, *supra* note 20, at 12, 15–19.

110 Gilson, Sabel & Scott, *supra* note 13, at 175.

111 *See, e.g.*, Revised Uniform Sales Act § 59 (Second Draft 1941) ("The procedure laid down in the sections attempts . . . to open the submission of peculiarly mercantile questions of fact to skilled specialists."). The merchant tribunal was competent to opine on the effect of any mercantile usage on the terms of a contract, "[t]he mercantile reasonableness of any action by either party," and "[a]ny other issue which requires for its competent determination special merchants' knowledge rather than general knowledge." *Id.* § 59(1)(c), (d). For discussion, see Scott, *supra* note 43, at 1040–41.

112 Scott, *supra* note 43, at 1040.

113 *See id.* at 1040–41; James Whitman, *Commercial Law and the American Volk: A Note on Llewellyn's German Sources for the Uniform Commercial Code*, 97 YALE L.J. 156, 174–75 (1988).

notion of incorporation of commercial norms was a serious drafting mistake.[114]

And so, the battle between text and context persists to our day under a nominally unified law of contract that applies its interpretation principles—whether text or context—to all contractual settings. The common law courts have proved remarkably faithful to Willistonian textualism. A large majority of courts retain "hard" parol evidence and plain meaning rules while recognizing equitable exceptions for fraud, misrepresentation, and the like.[115] In these jurisdictions, the risk is that unsophisticated parties may be trapped by the textualist rules that work well in facilitating contract design by sophisticated commercial parties. At the same time, a minority of courts have adopted Corbin's commitment to context, and in sales law the U.C.C. remains fully committed to Llewellyn's incorporation project.[116] This commitment remains firm even though the evidence is that courts generally have not attempted the empirical inquiry that Llewellyn believed essential to the success of the interpretive mission.[117] In short, rather than a set of interpretive doctrines that work to facilitate party preferences, we are left, instead, with the worst of both worlds.

In the next two Parts, therefore, we shift the focus from ex post contract interpretation to ex ante contract design in order to accommodate the two major deficits in the current doctrinal regime: (1) the failure of generalist courts to perform successfully as arbiters of context in disputes between commercial parties, and (2) the failure of a

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114 *See* Whitman, *supra* note 113, at 174–75; Scott, *supra* note 43, at 1040–41; Zipporah Batshaw Wiseman, *The Limits of Vision: Karl Llewellyn and the Merchant Rules*, 100 HARV. L. REV. 465, 505–06 (1987).

115 *See* Scott, *supra* note 6.

116 *See id.*

117 As noted, the "incorporation mechanism" introduced by Llewellyn has not functioned as he intended. *See supra* note 105 and accompanying text. Llewellyn intended the key instruction to courts—that they focus on commercially reasonable merchant practices—as a direction to admit expert evidence of the contracting customs of particular trades and then announce default rules that would apply to those particular populations of commercial parties. But the abandonment of the merchant tribunal doomed this effort from the start. Courts have subsequently interpreted these statutory instructions not as directions to incorporate specific commercial norms and customs but rather as invitations to use context as a source of subjective meaning—a determination of what the specific parties to the particular dispute "must have meant" by their agreement. This exercise sometimes results in reformation of the apparently clear express terms of the contract; other times it leads courts to decline to enforce commercial contracts in the face of apparently clear contractual language to the contrary. Scott, *The Case for Formalism*, *supra* note 52, at 854–55, 858–59; Imad D. Abyad, Note, *Commercial Reasonableness in Karl Llewellyn's Uniform Commercial Code Jurisprudence*, 83 VA. L. REV. 429, 452 (1997) ("The courts in effect are abrogating the responsibility that the Code drafters assigned to them by treating commercial reasonableness as garden-variety reasonableness, left for the lay juries to decide on a case-by-case basis with no systematic structure resulting from their decisions."); Bernstein, Trade Usage in the Courts, *supra* note 18, at 20–21.

unitary law of contract to apply its doctrines successfully to both legally sophisticated and unsophisticated contracting parties. We first show in Part III that legally sophisticated commercial parties choose the appropriate mix of text and context by crafting interpretive regimes that work in a complementary fashion with ex post adjudication so long as courts attend to the environment in which particular parties design their contracts. Interpretation becomes a matter of design, not doctrine. Commercial contractors designing bespoke contracts combine both text and context but in very different ways depending on the levels of uncertainty they are facing. When markets are thick and commercial parties can design contracts collectively, they are able to standardize the context and develop modes of interpretation that permit these standard understandings to be updated periodically, in effect endogenizing through design the process that Corbin sought through adjudication.

In Part IV we consider disputes where one or both of the parties are legally unsophisticated. Here we distinguish between consumer transactions on the one hand, and commercial transactions among parties for whom high transaction costs preclude them from choosing ex ante contract design on the other. As we will see, contextualization by expert courts works well as a design choice for commercial transactions among such legally unsophisticated parties. However, generalist courts have largely failed to accomplish the twin goals of (a) protecting consumers from difficult-to-detect forms of exploitation and (b) capably using context evidence to resolve disputes between legally unsophisticated commercial parties.

III
Text and Context in the Design of Contracts by Legally Sophisticated Parties

A. Choosing the Contract Form that Specifies the Role of Generalist Courts

The history of contract doctrine shows why common law courts have lost the capacity to combine text and context successfully through the adjudicatory process. In contrast to early English courts that were embedded in a homogenous economy, generalists courts today are removed from the particular contracting context and therefore impaired in their ability to divine how and when parties would braid both text and context in their contracts. Moreover, the merger of law and equity has placed doctrines that traditionally worked in tandem, albeit separately, in fundamental opposition one to the other. Contemporary textualist and contextualist theories thus struggle for control of this tattered institutional setting, each claiming the right to govern different transactional paradigms, knowing that,

under current doctrine, rules of interpretation are understood as mandatory and not subject to party choice—one size will be applied to all. Given the variety of situations, the limits of the generalist judiciary, and the doctrinal logjam, it is perhaps unsurprising that legally sophisticated commercial parties turn to creative contract design to accomplish two objectives: first to provide clear instructions to courts as to the appropriate mix of text and context; and, second, in light of those instructions, to invite courts to retain their historic superintending role to guard against opportunistic behavior.

In this Part, we present a typology of the conditions under which legally sophisticated commercial parties design contracts to accomplish their objectives. We characterize transaction settings on two dimensions. The first is the level of uncertainty[118]—whether commercial practices are stable and predictable, or frequently disrupted by, and thus needing to adapt to, changes in technical possibilities and market conditions. The second is the scope or thickness of the market—whether there are many traders or few engaged in a particular class of transaction. All else equal, the higher the level of uncertainty, the more difficult it is for parties to write, and courts to interpret, state-contingent contracts.

B. Designing Bespoke Contracts Under Varying Conditions of Uncertainty

1. *The Tradeoff Between Front-end and Back-end Contracting Costs*

In general, legally sophisticated parties designing bespoke contracts choose between text and context by trading off the front-end (or drafting) costs of contracting and the back-end (or enforcement) costs.[119] The fulcrum of this balance between front-end text and back-end context is the level of uncertainty.[120] The scale of the particular contractual setting—that is, the thickness of the market—dictates

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118 As stated in *supra* note 11, we follow Frank Knight and distinguish between risk and uncertainty.

119 For discussion, see generally Scott & Triantis, *supra* note 57.

120 Risk and uncertainty are a continuum, where any particular transaction will present elements of both risk and uncertainty but in different proportions. For expositional purposes, we will treat the term "low uncertainty" as covering situations in which probabilistic assessments can be made in important respects, and we will use the term "high uncertainty" for circumstances where probabilistic assessments are of little consequence. Thus, a high level of uncertainty exists when exogenous events that may affect the parties' obligations to perform are unknown or cannot be estimated probabilistically. Conditions of high uncertainty—generally the product of an exogenous shock—can occur in either bilateral or multilateral markets. In high uncertainty environments, where future contingencies cannot be estimated and parties must adapt collaboratively, the contracting process itself reflects continuous uncertainty. In that sense, uncertainty is endogenous to the contract. Under conditions of low uncertainty, sophisticated contractors can identify relevant risks that may impede future performance, estimate their occurrence probabilistically, and allocate those risks in the resulting agreement.

the institutions or interpretive regimes through which this tradeoff is determined or influenced.[121]

Writing a complete (or state-contingent) contract that specifies ex ante the outcome in each future state of the world significantly reduces ex post enforcement costs by dramatically reducing (if not eliminating) the need for courts to inquire into context. Such a contract not only provides the court with a clear and complete statement of the parties' obligations, but by reducing factual inquiry it also reduces the likelihood of opportunistic litigation driven by moral hazard on the part of the losing party.[122] Where both obligations and performance are observable and verifiable as in a complete contract, the likelihood of a court making a mistake in interpreting the contract is reduced and, correspondingly, so is the incentive for the party disfavored by the contract's outcome to engage in the litigation in the first place. Fidelity to the contractual text thus reduces the need for resort to context to address unanticipated events, as well as the opportunity for a losing party to exploit the court's discretion by seeking to persuade it to reallocate losses assigned to the losing party by the contract. In the setting of a state-contingent contract, therefore, courts are less mistake prone and parties less likely to encourage mistakes, resulting in less enforcement uncertainty and cost.

But the greater the uncertainty associated with a contract—the more difficult for the contracting parties to specify all the future states of the world in which the contract will have to be performed and the actions to be taken in each of those states—the more the contracting parties confront a dilemma.[123] They can choose specific rules covering possible outcomes, but in the face of uncertainty this approach comes at the cost of an increased likelihood that the ex ante–specified state contingencies will turn out to be incomplete or simply wrong ex post.[124] With this level of uncertainty, the parties may be better served by using a standard-based measure of performance—commercial reasonableness, for example—rather than detailed but incomplete or erroneous state-contingent rules.[125] Because a court applies a

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121 A thick market is one in which many commercial actors are exchanging goods or services by using the same or similar contracting behaviors and strategies. In this respect, similarity should be understood as a continuum. As we will see, broadly similar transactions may still have significant idiosyncrasies, which will influence how a multilateral contextualizing regime addresses markets that are thick at a general level and thinner with respect to particular transactions. *See infra* Part III.C.2–3. The polar opposite—a thin market—exists when each contracting party must negotiate a bespoke agreement with its counterparty. Here contracting is bilateral.

122 *See infra* notes 129–34 and accompanying text.

123 Gilson, Sabel & Scott, *supra* note 68, at 1390–91.

124 Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1099 (1981).

125 *See infra* notes 141–44 and accompanying text.

standard only after future events have occurred, the court will have more information, including the actual context of performance, than did the parties when they wrote the contract. As uncertainty increases, consideration of the context of performance in interpreting a standard thus has the potential to improve the accuracy of the outcome of any litigation, although with a concomitant increase in expected litigation costs. So the greater the ex ante uncertainty, the potentially more important the ex post resort to standards and therefore to context, but with the increased potential for judicial mistake and opportunistic-motivated litigation. This tradeoff directly influences how the parties design their contracts so as to optimize the front-end and the back-end costs of contracting.

As we will see, three characteristics of the contracting process complicate the relationship between uncertainty and the parties' choice of an interpretive regime that determines how much discretion to delegate to a court to ascertain and apply context ex post. The first is that the subject matter of the contract affects the extent to which judicial discretion over context increases enforcement costs. Where the subject matter of the contract makes the relevant context both observable and verifiable, the parties can more easily specify the relevant context, and courts are less likely to make an error in applying a standard in resolving litigation.

Second, the experience and expertise of the court or other adjudicative body that must determine and apply the relevant context affects the back-end costs of contracting, in particular the possibility that the court will make a mistake and, hence, the incentive for the disadvantaged party to pursue litigation. This experience and expertise, in turn, is a function of scale: the larger number the number of parties contracting over the same range of activities, the more likely courts will develop experience and expertise, which to some extent reduces the risk of error and thus of moral hazard–based litigation. As well, the larger the number of parties contracting over similar transactions, the more feasible it is to have collective determinations of context other than by means of formal adjudication, as through the adoption of industry standards or other joint efforts.[126]

Finally, the relationship between uncertainty and the decision to delegate discretion to a court is not monotonic. At some point, uncertainty becomes so pervasive that the parties cannot anticipate or specify the relevant context ex ante even through the invocation of broad standards of reasonableness and the like. Here the back-end costs of litigation, and especially the potential for moral hazard, then become so large that sophisticated parties forgo both text and context with

126 Gilson, Sabel & Scott, *supra* note 13, at 176–77.

respect to their substantive relation by resorting to collaborative contracting and other novel contract forms.[127] These new forms of contracting, which we have documented extensively in our earlier work,[128] function to confine the courts' ex post discretion. By using radically incomplete contracts as a means of limiting a reviewing court's jurisdiction to the commitment to collaborate rather than extending to performance of any substantive obligations that grow out of the collaboration, the parties rely entirely on informal mechanisms to enforce any contractual performance obligations.

2. *Low Uncertainty and Few Parties: The State-Contingent Contract Setting*

When uncertainty is low, sophisticated parties, even when acting in bilateral relations, can come close to designing a regime that embodies a complete contingent contract—the discrete contract setting in legal terminology.[129] Of course, we observe few circumstances where bespoke contracting can be this prescient. However, parties that are confident that they can approximate this ideal design contracts that specify dispute resolution by a generalist court but with clear instructions to confine interpretation to the text of the agreement. Because these parties can anticipate the context in which performance will occur, the contract itself will reflect it. Discursive exposition of goals, expectations, and business plans, whether in the contract's preamble or in particular sections, can supplement precise specifications of outcomes while still constraining a court's discretion to range more widely than the parties want. Consider, for example, the design choices open to sophisticated parties who wish to embed relevant context in their agreement. These parties can (and do) create a bilateral interpretive regime that provides clear directions to a court of the context within which the contract should be interpreted.[130] Such a regime might include (a) "whereas" or "purpose" clauses that describe the parties' business plan and the transaction;[131]

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127 *See infra* notes 145–50 and accompanying text.

128 *See generally* Gilson, Sabel & Scott, *supra* note 13; Gilson, Sabel & Scott, *supra* note 68.

129 The categorization in contract law scholarship of discrete versus relational contract is generally attributable to the work of Ian Macneil. *See generally* Ian R. Macneil, *The Many Futures of Contracts*, 47 S. CAL. L. REV. 1018 (1974); Ian R. Macneil, *Restatement (Second) of Contracts and Presentiation*, 60 VA. L. REV. 589 (1974); Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 85 (1978).

130 *See* Schwartz & Scott, *supra* note 4, at 954–55.

131 For example, see the following "purpose" clause from the Fountain Manufacturing Agreement between Apple Computer, Inc. and SCI Systems, Inc. (May 31, 1996) [hereinafter Apple/SCI Manufacturing Agreement], *available at* http://contracts.onecle.com/apple/scis.mfg.1996.05.31.shtml:

PURPOSE

(b) definition clauses that ascribe particular meanings to words and terms that may vary from their plain meaning;[132] and (c) appendices that provide more precise specifications governing performance, as well as any memoranda the parties want an interpreting court to consider in interpreting the contract's text.[133] Alternatively, the parties can specify in the agreement that the meaning of terms should be interpreted according to the customs and usages of a particular trade or industry.[134] Casual empiricism suggests that legally sophisticated commercial parties who write customized contracts that incorporate different mixtures of text and context pursue all of these strategies in one degree or another.

The contractual designation of context is not the only technique available to these contracting parties in a low uncertainty environment. Sometimes the difficulty in proving (verifying) the relevant context to a court can present a barrier to incorporating context in the written contract. Under these conditions, the parties can design an interpretive regime that uses options to overcome the nonverifiability of the relevant context.[135] For example, consider a research contract between a large pharmaceutical company and a small bio-

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> Apple and SCI entered into a Stock Purchase Agreement on April 4, 1996 (the "Stock Purchase Agreement") pursuant to which SCI will purchase Apple's manufacturing facility located at 702 Bandley Drive, Fountain, Colorado ("Fountain") and certain related assets.
>
> The parties desire that Apple engage SCI to assemble, test and package certain Products, Service Units and Spare Parts, as defined below, on a turnkey basis at Fountain on the terms and conditions of this Agreement.
>
> This Agreement defines the general terms and conditions governing all transactions between them for Products, Service Units and Spare Parts manufactured at Fountain. Individual "Product Plans" attached as Addenda to this Agreement, and incorporated herein by reference, define the specific terms and conditions for each Product, Service Unit and/or Spare Part. The initial Product Plans are attached to Exhibit A and numbered A-1 through A-11.
>
> Additional Products and Product Plans may be added to this Agreement by addenda to Exhibit A signed by both parties. Such addenda will be numbered sequentially, A-12, A-13 and so on.
>
> In consideration of the above and the mutual promises contained herein, Apple and SCI agree as follows[.]

132 *See, e.g.*, Data Management Outsourcing Agreement between Allstate Insurance Company and Acxiom Corporation, art. 2 (Mar. 19, 1999) [hereinafter Allstate/Acxiom Outsourcing Agreement], *available at* http://contracts.onecle.com/acxiom/allstate.outsource.1999.03.19.shtml (defining, in the "definitions" clause, thirty-four technical or nonstandard meanings, including specialized meanings of "Agreement," "Confidential Information," "Data Integrity," "Current Projects," "Affiliate," "End-User," "Material Default," "Party," "Person," "Problem," "Term," "Work Order," and "Work Product").

133 *See, e.g.*, Apple/SCI Manufacturing Agreement, *supra* note 131, art. 22 (providing a list of general terms ranging from the relationship of the parties to complete agreement).

134 Schwartz & Scott, *supra* note 54, at 585–86.

135 *See* Josh Lerner & Ulrike Malmendier, *Contractibility and the Design of Research Agreements*, 100 AM. ECON. REV. 214, 214–16 (2010).

technology company where the parties may both know and be able to observe the relevant context a court should apply, but be unable to specify that context in the agreement. In this case, options can protect the pharmaceutical from two types of opportunistic behavior by the biotech in providing the contracted-for research. First, the biotech, which typically has a number of research projects with other companies as well as proprietary research, may be tempted to use the contractual payments to cross-subsidize other projects, to the disadvantage of the pharma and its project. Second, the concern is that the biotech will be disproportionately benefited from academic research vis-à-vis the pharma and will underinvest in the commercially oriented research desired by the pharmaceutical in favor of investments in academic research.[136]

Here the problem is not uncertainty—both parties know and understand the object of the contract and the desired inputs to performance. The uncertainty relates only to output.[137] In this circumstance, the biotech can be policed by granting the pharmaceutical an unconditional option to terminate the relationship and secure broad property rights to the research output on payment of a termination fee.[138] The termination fee, in turn, constrains responsive opportunism by the pharmaceutical company. This use of options may viably substitute for the ex ante incorporation of context in a low uncertainty environment because the inputs that may be subject to opportunism are fully observable by the contracting parties even if not verifiable to a court.[139]

3. *Context and Contracting with Moderate Uncertainty: Bilateral Contracts with Standards*

Now suppose the contracting parties confront moderate uncertainty, such that they can identify what should happen in some but not every future state of the world. One clear example is the hiring of a specialized agent, say a sales representative. The parties can specify what they want the agent to accomplish as matters stand at the time of drafting the contract: they can identify the category of product and

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136 *See, e.g.*, Walter W. Powell, *Inter-Organizational Collaboration in the Biotechnology Industry*, 152 J. INSTITUTIONAL & THEORETICAL ECON. 197, 211–12 (1996) ("Building on preexisting ties of its scientists, a company makes gains through cooperation.").

137 Lerner and Malmendier posit that opportunistic behavior by the biotech is observable but not verifiable—the pharmaceutical company will know when the biotech is skewing the use of the invested funds or the orientation of the project, but will not be able to prove the misbehavior to the court. *See* Lerner & Malmendier, *supra* note 135, at 240.

138 *See id.* at 238–39.

139 As we will see, however, an interpretive regime based on options is unlikely to succeed in a high uncertainty environment where it may be difficult or impossible to determine which party will be in a position to act opportunistically, and thus it will be unclear to whom the option should be allocated. *See infra* Part III.B.4.

customer, or geographic region, and they can specify sales goals. But they cannot detail how the agent will try to market the product, how the agent will allocate her time across different products, or what adjustments the agent should make if market conditions change or competitors alter their strategy, perhaps in response to her activity. Similarly, the party charged with securing regulatory approval and commercializing a new drug under a license from the owner of the intellectual property is typically charged with using "commercially reasonable efforts" to accomplish these tasks,[140] reflecting the fact that the appropriate strategy is dependent on the sequential outcome of uncertain events, including the results of clinical tests, the path of the regulatory process, and competitive conditions—what other drugs have entered the market—by the time that interpretive approval is secured and commercialization can begin.

In this range of uncertainty, parties combine precise terms—state-contingent rules—and contractual standards that carry with them directions about the context through which the standard should be applied. In the sales examples, and in other circumstances when one party contracts for the counterparty's expertise, the ultimate aim of the contract is to secure the counterparty's active exercise of judgment. When circumstances change in an unanticipated way the agent's obligation is to apply her expertise to adjusting effectively to the new conditions. This form of relationship is memorialized in a formal contract by the use of a standard such as best efforts: a characterization rather than a specification of the contracted-for performance.

Commercial contracts often include both precise rules and general standards, and courts actively interpret and enforce such standards by reference to context evidence. For example, contracts may state one party's performance obligation as to make "commercially reasonable efforts," "reasonable efforts," or "reasonable best efforts."[141] In terms of the tradeoff between ex ante and ex post contracting costs, the use of a standard as opposed to a rule necessarily increases ex post contracting costs. It is harder to verify performance when specified by a standard; the court must first identify a "proxy" against which to measure performance, an intermediate step that is

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140 *See* Tai-Heng Cheng, *Power, Norms, and International Intellectual Property Law*, 28 MICH. J. INT'L L. 109, 149 (2006).

141 *See* Univ. of Mo.-Columbia, *CORI Contracts Library*, CONTRACTING & ORGS. RESEARCH INST., http://cori.missouri.edu (last visited Oct. 14, 2014) (total contracts in CORI database: 24,965; contracts with "best efforts" terms: 4,328 (17.34%); contracts with "reasonable expenses" terms: 2,584 (10.35%); contracts with "reasonably withheld" terms: 38 (0.0015%); contracts with "unreasonably withheld" terms: 3,525 (14.12%); contracts with "reasonable" terms: 13,281 (53.20%)).

not required when the contract specifies the terms of performance.[142] For this reason, disagreement over whether a performance standard has been met is much less amenable to pretrial resolution than is a rule, and the potential for moral hazard—the party disfavored by the change in circumstances opportunistically misleading a court into reallocating the burden of events in its favor—is increased.

Under these conditions of moderate uncertainty, standards also have special utility. Courts assess performance with respect to standards only after the relevant future events have occurred. Thus parties can obtain the advantage of hindsight: at the time for dispute resolution, the court has information that at the time of drafting the contract the parties lacked. Thus, here the parties design an interpretive regime that combines rules and standards so as to optimize the admissibility of context evidence over two dimensions: *when* the court will look to context and *who* decides what context matters.[143] The combination of general and specific terms, therefore, offers sophisticated contracting parties the ability to combine the text with context evidence that is revealed over the course of contract performance.[144] The more effectively context can be harnessed to resolve uncertainty in the judicial application of contractual standards, the more attractive the use of standards that take advantage of the court's better information ex post.

When, and the extent to which, parties design a regime that deploys broad standards depends on a particular form of uncertainty—how effectively context can be used to reduce the risk that a court will (or can be persuaded to) misunderstand or misapply the standard. As discussed earlier, the outcome will depend in the first instance on the subject matter of the contract and the industry, and on the surround-

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142 Gilson, Sabel & Scott, *supra* note 68, at 1390. The use of a proxy results in a contractual version of the Heisenberg uncertainty effect in physics. In physics, the problem is that measuring one attribute of a phenomenon reduces the observer's ability to measure the other attribute. In contracting, using a proxy to measure one attribute causes the observed party to reduce provision of a complementary attribute that is not being measured.

143 At the time of contract formation the parties have a comparative advantage over courts in setting the interpretive mix since the parties share the benefits of efficient contracting; at the time of subsequent litigation, however, the court will have the benefit of hindsight. Uncertainty has been resolved, and the court sees realized facts rather than probability distributions. Because the parties cannot foresee all contingencies, they can delegate to the court the task of completing the contract ex post by considering relevant context. They indicate this intention by adopting a general contract term—a standard—that directs the court to limit its efforts to recovering only that context evidence relevant to the particular obligation embedded in the contractually specified term. *See* Scott & Triantis, *supra* note 57, at 843–45.

144 The options available to the parties are even broader than the stark choice between a rule and a standard. With the aid of interpretation maxims, parties can design *combinations* of specific and vague terms that more precisely define the "space" within which the court has discretion in proxy choice. *Id.* at 848.

ing circumstances. At one end of a continuum, if the subject matter, industry, and surrounding circumstances are themselves clear enough to narrow the context that will appear relevant to a reviewing court, the parties will need to do little more through drafting beyond a reference such as "commercial reasonableness." Alternatively, at the drafting stage the parties can specify in greater detail the context that will be relevant—what industry, what kind of products, and, when possible, even the relevant proxy the court should use to measure performance under the standard. In both cases, the contractually specified standard directs the court to make use of context in addition to text, but limits its inquiry into context to that relevant to the particular obligation embedded in the standard. As with bespoke contracting under conditions of low uncertainty, the parties in designing the contract choose the interpretive regime—the balance between text and context that best suits the level and kind of uncertainty the transaction protects.

4. *Collaborative Contracting*

What happens when uncertainty is high but traders are few, and their relations are of necessity idiosyncratic? Here the thinness of the market motivates the parties to create bilateral interpretive regimes for exploring possibilities for collaboration without creating intolerable mutual vulnerability to opportunism. Neither textual nor contextual interpretation is helpful since under high uncertainty the parties themselves can neither set prospective rules to govern their conduct, nor even specify the relevant context by which conduct might be assessed. This solution to this problem is exemplified by what we have elsewhere called "contracting for innovation."[145] In these circumstances, parties are contracting over the creation of something whose features, and the contributions of each of the parties, are unknowable and will emerge only after many iterations between the contracting parties. Moreover, this uncertainty will not be resolved by the passage of time, as is the case where a court can use context to apply a standard after events have resolved uncertainty. Rather, the uncertainty is continuous; the object of the contracting process will continue to evolve and new elements of uncertainty arise to replace those that have been resolved.[146]

Thus, when uncertainty is high and continuous, the parties cannot trade off between ex ante and ex post contracting costs. No stable ex post period arises in which standards can be used to fill in uncertainty-driven gaps in an incomplete formal contract. The contracting problem then is to craft a structure that is neither state-contingent nor

145 Gilson, Sabel & Scott, *supra* note 11, at 435.
146 *See id.* at 448–51.

standard-based, and that (a) induces efficient, transaction-specific investment by both parties; (b) establishes a framework for iterative collaboration and adjustment of the parties' obligations under conditions of *continuing* uncertainty—circumstances when the resolution of one element of uncertainty merely gives rise to another; and (c) limits the risk of opportunism that could undermine the incentive to make relation-specific investments in the first place.[147]

The common challenges facing parties designing collaborative interpretive regimes give rise to solutions with common elements: the parties design an interpretive structure that braids formal and informal contracts in a fashion that is neither state-contingent nor standard-based, because it does not address performance of any substantive obligations at all. In general, the formal contract is process- rather than outcome oriented. It defines a process of collaboration—typically a regime of ongoing review and information exchange by which the parties mutually evaluate their capacities and intentions—that substitutes functionally for ex ante specification of the desired product by building trust that responds to the fact that specifications are the outcome of contracting for innovation not an input.[148] Thus, in sharp contrast to contracting in low uncertainty en-

147 *See id.* at 455–58.

148 For a sample of collaborative contracts that combine formal and informal elements, see Allstate/Acxiom Outsourcing Agreement, *supra* note 132 (contract for Acxiom to develop a data-acquisition system to support Allstate's underwriting of new business in auto and property insurance); Agreement between Phoenix Technologies Ltd. and Intel Corporation (Dec. 18, 1995), *available at* http://contracts.onecle.com/phoenix-tech/intel.supply.1995.12.18.shtml (supply contract for Phoenix to be a principal supplier of system-level software to Intel); General Terms Agreement between The Boeing Company and Spirit Aerosystems Inc. (June 30, 2006) (on file with authors) (general terms agreement covering purchase orders by Boeing for particular product to be supplied by Spirit); Component Supply Agreement between American Axle & Manufacturing, Inc. and General Motors Corporation (June 5, 1998) (on file with authors) (requirements contract for motor vehicle components to be supplied by AAM to GM); Development Agreement between Nanosys Inc. and Matsushita Electric Works, Ltd. (Nov. 18, 2002), *available at* http://contracts.onecle.com/nanosys/matsushita.rd1.2004.02.08.shtml (collaboration agreement to develop photovoltaic devices with nano components in Asia); Apple/SCI Manufacturing Agreement, *supra* note 131 (contract manufacturing agreement for SCI to produce designated products at the Fountain, Colorado, plant); Research, Development, and License Agreement between Warner-Lambert Co. and Ligand Pharmaceuticals Inc. (Sept. 1, 1999) [hereinafter Warner-Lambert/Ligand Agreement], *available at* http://contracts.onecle.com/ligand/warner.rd.1999.09.01.shtml (pharmaceutical research and development collaboration between "big pharma" and "little pharma"); Collaboration and License Agreement between Pharmacopeia, Inc. and Bristol-Myers Squibb Co. (Nov. 26, 1997) [hereinafter Pharmacopeia/Bristol-Myers Squibb Agreement], *available at* http://contracts.onecle.com/alpha/471.shtml (same); Long Term Agreement between John Deere & Company and Stanadyne Corporation (Dec. 14, 2001) [hereinafter John Deere/Stanadyne Agreement] (on file with authors) (five-year supply contract for the purchase of fuel filtration systems, injection nozzles, and related products by Deere from Stanadyne); Airbus A320 Purchase Agreement between AVSA, S.A.R.L. and New Air Corporation (Apr. 20, 1999), *available at* http://contracts.onecle.com/jetblue/airbus.a320.1999.04.20.shtml (Jet-

vironments, the process, if successful, defines the specification, not the other way around. In each case, the parties make relation-specific investments in learning about their collaborator's capabilities and the nature of the project that raise the costs of switching to new partners, and so restrain either party from taking advantage of their mutual dependence.[149]

Accordingly, the parties designing a collaborative contract craft an interpretive regime in which, despite—indeed, because of—the high uncertainty, there is no role for a court to incorporate context in resolving disputes between the parties. The uncertainty exists with respect to whether a product in the end will be developed, whether actual sales will result, and how the parties will continue to interact in the future. But because the uncertainty concerning these matters is so high and continuous, the parties do not contract over outcomes at the outset; there is no substantive set of contractual obligations for a court to enforce. Rather, the parties design the collaborative process to build switching costs through formally specified process-based learning, and then rely on informal enforcement mechanisms for substance. Put differently, in the face of high and continuous uncertainty, resolving disputes over the obligations that arise out of this relationship cannot be delegated to generalist courts; the parties create their own means of enforcing their commitments to each other through a contractually specified process. The effect of this design framework is to limit judicial oversight to sanctioning "red-faced" abuse of the process-oriented regime—i.e., the secret misappropriation by one party of knowledge gained in the collaboration to another venture—without inviting a court to convert the exploration of collaborative possibilities into a contractual obligation to actually do so.[150]

Blue and Airbus purchasing agreement); see also George S. Geis, *The Space Between Markets and Hierarchies*, 95 VA. L. REV. 99, 100, 103–05 (2009) (citing examples of collaborative contracts).

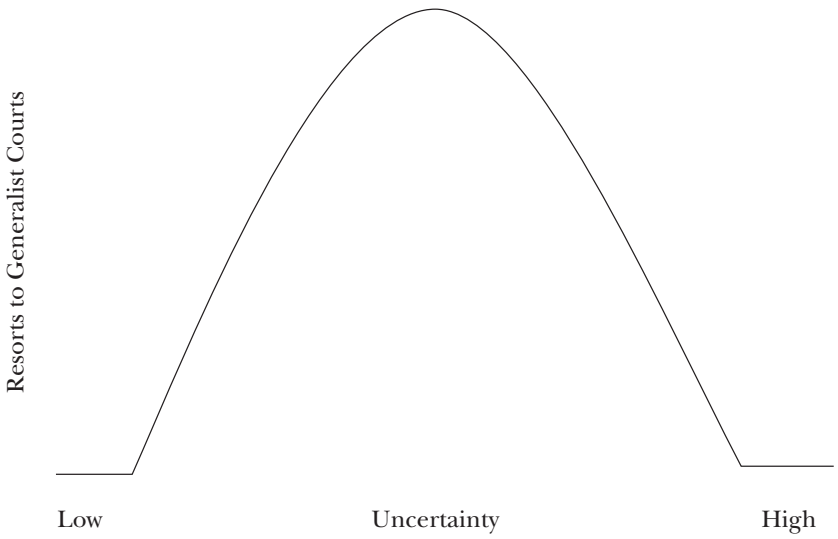
149 The collaborative contract does not, however, commit either party to develop, supply, or purchase any product since by definition the product that may come out of the collaborative process cannot be specified at the outset. So how do the parties address the purchases and sales that ultimately will result from a successful collaboration? That commitment emerges from the resulting trust relationship, where the barrier to ex post opportunism results from increased switching costs generated by the collaboration process itself. Gilson, Sabel & Scott, *supra* note 11, at 484.

150 *See, e.g.*, Eli Lilly & Co. v. Emisphere Techs., Inc., 408 F. Supp. 2d 668, 696–97 (S.D. Ind. 2006) (holding that the contractual remedy for breach of a collaborative agreement is limited to the right to terminate and retain accrued scientific information); Medinol Ltd. v. Boston Scientific Corp., 346 F. Supp. 2d 575, 596 (S.D.N.Y. 2004) (finding that the parties' close collaborative relationship and Boston Scientific's stealth and secrecy showed it had acted in bad faith by setting up an unauthorized manufacturing line); Shaw v. E.I. DuPont de Nemours & Co., 226 A.2d 903, 906–08 (Vt. 1967) (affirming a damage award for breach of an implied covenant not to use a patent beyond the scope of license).

5. *Summary*

In this Part, we have described how legally sophisticated parties contracting over a discrete transaction design interpretive regimes that specify the mix of textual and contextual interpretive elements, and so the extent to which generalist courts are delegated the role of applying context in interpreting the contract. The parties do not choose text or context. Rather the parties choose the mixture of text *and* context that fits the underlying transaction, ranging from (a) bespoke state-contingent contracts that reject any ex post context; to (b) contracts that combine precise terms with general standards that a court will interpret ex post subject to the parties' specification of the context the court should apply; to (c) contracts where the very point is to specify a collaborative process through which the parties will create the context that supports the subsequent informal mechanisms that will govern their substantive obligations going forward. We have shown that the specific mix of text and context the contracting parties choose is driven by the impact of uncertainty on the tradeoff between the ex ante and ex post costs of contracting. Text *and* context, not text *or* context. Figure 1 stylizes the relation between uncertainty and these contracting parties' resort to generalist courts to apply context to contractual interpretation. As noted above, this relationship is not monotonic.

FIGURE 1. THE RELATION BETWEEN UNCERTAINTY AND RESORT TO GENERALIST COURTS



At low levels of uncertainty, parties will exclude ex post judicial resort to context. The gain in precision from filling small gaps in contractually specified contingencies with broad standards to be applied ex post by courts is outweighed by the moral hazard–based incentive to litigate that results from the realization of adverse events. As uncertainty increases such that the parties can specify the goal but not the steps that must be taken to achieve it, nor the accommodations that would be required by changes in the commercial environment, resort to standards—like commercial reasonableness—that invite judicial explorations of context becomes compelling. Here, by crafting the reference to context in a fashion that focuses the court's inquiry, whether through the substance of the contract or the clarity of the relevant industry, the parties can get the benefit of judicial hindsight but with limits on the cost of litigation. Since the success of moral hazard–motivated litigation depends on the court making an interpretive mistake, the expertise and experience of the court reduces the likelihood of mistake and hence the incentive to bring such litigation. Thus, resort to better courts expands the range of uncertainty over which the parties can rely on judicially interpreted standards. Finally, as uncertainty becomes fully Knightian, and state-contingent contracting becomes close to impossible rather than merely gap-ridden, reliance on generalist courts to interpret context drops dramatically; the parties' formal contractual arrangement then focuses on specifying a collaborative process, the goal of which is to create the context that will support the informal mechanisms of trust that will regulate the actual provision of goods and services.

C. Designing Contracts with Scale Under Varying Degrees of Uncertainty: Multilateral Interpretive Regimes

As the number of parties contracting over similar transactions increases, the range of interpretive options available to the parties increases. With scale, knowledge of the relevant context is located in the parties and not readily accessible to a generalist court whose knowledge must necessarily come through the litigation process. As we saw in Part II.B, this is the setting that concerned Karl Llewellyn, where generalist courts simply could not access the collective knowledge held by numerous parties of the context in which they acted and hence could not determine the context necessary to interpret contracts.[151] Llewellyn's response to generalist courts' information disadvantage was to substitute a merchant jury for the court as the vehicle for applying context. We show in this section that Llewellyn had the problem right but the answer wrong. Rather than mandating a partic-

151 *See supra* notes 103–14 and accompanying text.

ular mechanism by which the relevant market's collective knowledge of context could be extracted, we observe that, as with bespoke contracts, the parties themselves determine the collective interpretive regimes by which context is applied to their contracts. And as with bespoke contracts, the design of these collective mechanisms is importantly a function of the level of uncertainty associated with the particular category of transaction.

1. *Low Uncertainty and the Problem of Judicial Ignorance*

Take first the setting where trade practices are stable and well understood by a substantial community of traders. Uncertainty is low, as with bilateral state-contingent contracts, but markets are thick. Here the presence of scale allows an approach different from bespoke contracts: the key contract design choices are made collectively. The contracting parties act through trade organizations and similar collective entities that can take advantage of scale economies to formulate a contractual design that reduces contracting costs for all the individual members of the community. But despite the regularities of dealings, and the trading community's easy familiarity with their particulars and the distinctive vulnerabilities to which they can give rise, a generalist court cannot reasonably be expected to have knowledge of trade practices or be able conveniently to obtain it. The problem here, in other words, is that a generalist judge is and will remain ignorant of the common knowledge of the trade. The key design strategy, therefore, is to render insider understanding in terms that can be incorporated into everyday contracting, establish methods for the expeditious resolution of disputes arising under these agreements, and institutionalize a process for keeping terms and forms of dispute resolution abreast of developments.

In "The Case of the Spoiled Cantaloupes," Hart and Sacks describe, under the name of an "institutional settlement," just such a collective regime for the regulation of contracting in perishable agricultural commodities.[152] The regime was initially created to address a disruptive practice (the "rejection evil") that recurrently threatened commerce in these goods: when prices fell against them, buyers evaded their commitments by using minor nonconformities as pretexts to reject—as we have seen, this is the standard move by the party who has been disadvantaged by the resolution of uncertainty. Small shippers were typically unable to salvage rejected goods or to pursue litigation in distant locales. The dispersed and fragmented character of the industry impeded efforts, over decades, to address the problem

152 *See* HENRY M. HART, JR. & ALBERT M. SACKS, THE LEGAL PROCESS: BASIC PROBLEMS IN THE MAKING AND APPLICATION OF LAW 10–68 (William N. Eskridge, Jr. & Philip P. Frickey eds., 1994).

through coordination of private trade associations. In 1930, Congress passed the Perishable Agricultural Commodities Act (PACA), which makes it a violation of federal law for "any dealer to reject or fail to deliver . . . without reasonable cause any perishable agricultural commodity" in an interstate transaction.[153] The Act instructs the Secretary of Agriculture to promulgate regulations to guide interpretation of contract terms allocating risks specific to the industry between buyers and sellers, to operate an arbitration process to adjudicate claims at reasonable costs, and to administer a licensing scheme to screen irresponsible buyers and sellers from the industry.[154] Here the strategy is to use legislation as a coordinating mechanism, which had been lacking.

In the case from which the problem was derived, a Springfield, Massachusetts, wholesaler rejected an extensively spoiled shipment of melons that did not satisfy the contractual specification and abandoned the cantaloupes at the loading dock in Springfield, from where the railroad eventually disposed of them for salvage value.[155] The Chicago broker who sold the fruit sued for the contract price. The district court, disregarding the PACA regime, treated the case under the general law of sales, and held that the buyer's obligation to the seller for the purchase price could be reduced by the decrease in value caused by the cantaloupes' nonconformity.[156] Prior to the adoption of the U.C.C., the common law of sales was ambiguous as to whether the seller's shipment of nonconforming goods permitted the buyer to reject, instead of accepting and claiming damages for their reduced value; whether, if there was found to be a right to reject, the rejecting buyer had a duty to assist the seller by disposing of the spoiled goods; and whether the buyer's failure to salvage or wrongful rejection led to offsetting damages or a complete forfeiture of the purchase price. The common law thus seemed to lack the necessary resources for effectiveness in this domain.[157]

The court of appeals reversed the district court decision on the ground that the buyer had forfeited his right to offsetting damages by failing to salvage.[158] Because forfeiture was developed by the Depart-

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153 *Id.* at 33 (quoting Perishable Agricultural Commodities Act (PACA) of 1930 § 2(2), 7 U.S.C. § 499b(2) (2012)).

154 *See id.* at 33–36.

155 *Id.* at 10–68.

156 *See id.* at 50–53 (quoting Joseph Martinelli & Co., Inc. v. L. Gillarde Co., 73 F. Supp. 293 (D. Mass. 1947)).

157 The problem of lost value by inefficient salvage is largely solved in the U.C.C. *See* U.C.C. §§ 2-603, 2-604 (2014). The problem of opportunistic rejection is only partially solved by § 2-508. For discussion, see generally Jody S. Kraus, *Decoupling Sales Law from the Acceptance-Rejection Fulcrum*, 104 YALE L.J. 129 (1995).

158 *See* HART & SACKS, *supra* note 152, at 57–58 (quoting L. Gillarde Co. v. Joseph Martinelli & Co., Inc., 169 F.2d 60 (1st Cir. 1948)).

ment of Agriculture, under PACA, as a key to elimination of the rejection evil, the court properly deferred to the institutional judgment of the collective entity that had designed the contract. The determination of context is made by the collective mechanism, not by a generalist court.[159]

As Lisa Bernstein has shown in well-known studies of contracting in the cotton, grain, and diamond industries,[160] collective regimes of this kind frequently arise through private organization, and disputes arising within them can be disposed of by private arbitration. But public or private, dispute resolution in these regimes is "textualist": parties are expected to incorporate standard language into their contracts, and are held to its terms. Claims of a pattern of dealings that diverges from the text are summarily rejected. This formalism is workable for two reasons. First, it is underpinned by an interpretive regime providing for the updating of formal standard terms through periodic consultation with the transaction parties—a collective mechanism to determine context. Second, parties routinely diverge from the formal terms of the contract—indeed, there is a course of dealings that does diverge from the text. However, the arbitrators' application of textualist interpretation relegates divergence from the text to informal relational contracting supported by a reputation mechanism. If the parties feared that the arbitrators would take informal adjustments into account, they would be unwilling to make them.[161] Thus, it is the interpretive regime and the informal adjustment mechanisms that it fosters, and not the arbitral body, that does the contextualizing.

2. *High Uncertainty and the Problem of Joint Risk Mitigation*[162]

Consider next the setting of high uncertainty and thick markets. This domain has not been as prominent in the study of contracts as the preceding one, but for reasons we have discussed elsewhere it is

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159 Note that judicial deference should be limited to matters related to collective determination of context. In contrast, generalist courts should not hesitate to overrule the Secretary in order to protect buyers from seller fraud or sharp practice. In short, generalist courts' expertise is superior in matters involving possible opportunism, as opposed to determination and interpretation of context. This is precisely the oversight role that generalist courts properly play in support of sophisticated contracting parties, where the courts are not at a systematic information disadvantage. The successful maintenance of a collective interpretive regime requires parties to design a contractual structure that impels generalist courts to adopt a combination of deference and oversight.

160 *See* Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1771–77 (1996); Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEG. STUD. 115, 119–30 (1992); Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724, 1745–54 (2001) [hereinafter Bernstein, *Private Commercial Law in the Cotton Industry*].

161 Gilson, Sabel & Scott, *supra* note 13, at 203–04.

162 The discussion that follows draws on our previous work, *id.* at 210–13.

rapidly increasing as a matter of practical concern.[163] The problem here is not the same as a generalist court's ignorance of established understanding or practices, as in the low uncertainty case. Under conditions of high uncertainty both generalists and insiders are unsure about what the solution might be. The aim of this interpretive regime is therefore not the elaboration and codification of established knowledge to which a generalist court does not have access, but rather the organization of collective exploration of possibilities for problem solving, especially the mitigation of risks that can only be addressed through exacting, common efforts by all market participants. Here, as in the case of bilateral collaborative contracting, the role of the generalist court in interpretation is limited to policing opportunistic efforts to evade the collective commitment.

Food safety illustrates the class of risk that motivates the formation of this type of collective contractual design. As the supply chains for foodstuffs lengthen and ramify, pathogens can enter in innumerable and rapidly changing ways that are very difficult to trace. Undetected, food contamination is rapidly propagated by processing (through mixing of foodstuffs and secondary contamination of equipment), and then disseminated through extensive distribution networks. Since the failure of any actor to scrupulously adhere to the good practices can undo the efforts of all the others, adhesion to the requirements of the regime will be a precondition to contracting in the market.

The California Leafy Green Products Handler Marketing Agreement (LGMA) is an exemplar of a collective regime of this type.[164] Leafy greens became a salient concern after highly publicized disease outbreaks from tainted spinach and lettuce in 2006.[165] Leafy greens pose particular risks because they are often eaten raw (cooking kills most micropathogens) and because these vegetables, produced in larger scale operations than in the past, are often sold in "salad mixes" that mingle pieces picked in different locations, thus multiplying the

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163 *Id.* at 210–11.

164 *See* California Leafy Green Products Handler Marketing Agreement (Mar. 5, 2008), *available at* http://www.cdfa.ca.gov/mkt/mkt/pdf/CA%20Leafy%20Green%20Products%20Handler%20Agreement.pdf. The state of California recognized the LGMA under the authority of a state marketing act that confers antitrust immunity on organizations of agricultural producers for various purposes. *See id.* art. XI. There are currently about 120 members, accounting for about ninety-nine percent of California leafy greens production. *See* FAQ, LGMA, http://www.lgma.ca.gov/about-us/faq/ (last visited Nov. 1, 2014). There is a parallel regime in Arizona. *See* Arizona Leafy Green Products Shipper Marketing Agreement (Sept. 30, 2011), *available at* http://www.arizonaleafygreens.org/arizona-leafy-greens-shipping-agreement-2012/.

165 *See* Shermain D. Hardesty & Yoko Kusunose, *Growers' Compliance Costs for the Leafy Greens Marketing Agreement and Other Food Safety Programs* 2, UC Small Farm Program Research Brief (Sept. 2009), *available at* http://sfp.ucdavis.edu/files/143911.pdf.

possibilities for cross contamination. Federal food regulation has focused traditionally on post-farm industrial processing where there is less uncertainty concerning the source of contamination, and was ill prepared to address the numerous "critical control points" on the farm by which pathogens could enter this food chain.

The LGMA designates safety standards or "best practices" for the farms from which the handlers buy.[166] These standards require growers and processors to prepare plans identifying hazardous control points, detailing the measures undertaken to mitigate the risk, and reporting the results of tests verifying the efficacy of these measures. The LGMA additionally requires each handler to maintain records that permit identification of the farm and field from which all components of its products originate should contamination later be discovered.[167] The members commit to deal only with farms that comply with the standards. As in the case of the low uncertainty regimes discussed above, the ultimate sanction for noncompliance is suspension or withdrawal of a recalcitrant member's right to use a service mark, and thus temporary or permanent exclusion from the industry.[168]

As in our previous examples, the success of the LGMA and the durability of the collective collaboration among industry participants demonstrates how relatively unsophisticated commercial parties, such as the growers of leafy greens, can take advantage of economies of scale to design a legally sophisticated interpretive regime: this regime assigns to the industry group the responsibility for establishing the baseline of standards of behavior and processes, and assigns to courts the more limited role of identifying significant deviations from that baseline in particular cases.[169]

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166 *See* California Leafy Green Products Handler Marketing Agreement, *supra* note 164, art. III(A)(3).

167 *Id.* art. IV.

168 *Id.* art. V(D).

169 The 2010 federal FDA Food Safety Modernization Act reinforces the mechanisms embodied in the LGMA. FDA Food Safety Modernization Act, Pub. L. No. 111-353, §§ 102–05, 201–05, 301–07, 124 Stat. 3885, 3923, 3953 (2011) (amending the Federal Food, Drug, and Cosmetic Act to have more stringent, detailed, and preventive requirements). The Act mandates that each food-processing facility develop, implement, monitor, validate, and update a plan for hazard control. *Id.* § 103. The Act also directs the Food and Drug Administration to set standards for fruits and vegetables, *id.* § 105(a), and "[i]t seems clear that such standards will be developed in a way that relies on organizations like LGMA" to continue and advance the joint exploration of risks and possible mitigations on which this type of regime depends. Charles F. Sabel & William H. Simon, *Contextualizing Regimes: Institutionalization as a Response to the Limits of Interpretation and Policy Engineering*, 110 MICH. L. REV. 1265, 1284–85 (2012).

3. *High Uncertainty with Moderate Scale: The Delaware Court of Chancery*

Consider now the setting where there are a large number of highly complex transactions that share general features, but where each transaction has significant idiosyncrasies, and the common background conditions shift rapidly. This is the setting in which, for example, the legal rules governing the obligations of boards of directors in corporate acquisitions are applied. The uncertainty arises not from the unforeseeable, unintended consequences of incorporation of new actors, products, and production processes into a highly interdependent, if not joint, endeavor—as in maintaining the safety of a food supply chain. Rather the uncertainty arises through the strategic interaction of corporate actors intent on manipulating open-ended rules in volatile environments to advance their private interests. On the one hand, the parties know the general rules that apply, but on the other hand, also know that the other will seek to exploit those rules to its advantage. To the extent that actors in such an environment take collective actions to reduce the very uncertainty to which they contribute, with the complementary aim of reducing the chance of judicial error in ex post application of standards like fiduciary duty, they will need to rely on expert judges with significant experience in the field: to rely, that is, on a specialized court of equity. The specialization of the court and its equitable powers assure parties that, despite the impossibility of codifying decision rules, judicial decisions will be taken with the fullest possible awareness of current understandings of good practice, that is, the court can with reasonable accuracy assess the context because it is part of it. Thus, the chancery court applies a standard—fiduciary duty—to assess the parties' behavior. The special advantage of the chancery court, as we saw in Part III.B.1, is that a court's experience and expertise expands the range of uncertainty over which a standard effectively trades off between ex ante contracting costs and ex post enforcement costs.[170]

One way to understand why a majority of U.S. public corporations choose Delaware as an incorporation state is that it serves to allocate to the Delaware Court of Chancery jurisdiction to resolve fiduciary duty issues. Delaware corporate law is enabling, that is, it gives corporations wide latitude to adopt specific rules governing their behavior; organization design is left to the parties just as is contract design in a textualist interpretive regime. In fact, Delaware corporations appear not to accept that invitation, writing articles of incorporation and bylaws that largely address formal issues like meeting dates, because a corporation's circumstances and the evolution of the mar-

170 *See supra* Part III.B.4.

ket for corporate control are too uncertain to specify ex ante conduct rules that will govern all of the corporation's activities in the future.[171] So all ex ante rules governing formal issues are subject to ex post court review of the context because the parties can be expected to manipulate those rules to their advantage when circumstances make it to their advantage to do so. Formal compliance with ex ante rules thus remains subject to ex post court review through a standard—the director and officer's overriding obligation of fiduciary duty.[172] Like contracting parties operating under uncertainty, a corporation assures that as circumstances reveal ex post gaps in its articles of incorporation and bylaws as a result of uncertainty, they will be filled by a standard applied by a court with the expertise to reduce the likelihood of error. This is accomplished by incorporating in a jurisdiction that has sufficient scale of incorporations that its judges develop the necessary experience and expertise.[173] In this respect a modern court of equity resembles the early English courts of equity—the chancery court has deep knowledge of the community whose disputes it resolves, as did the early courts of equity with respect to the homogenous economy in which their litigants operated.

Both the cost and benefit of delegating to a court or other arbiter the task of assessing context ex post goes up with uncertainty; but the shape of the curve in Figure 1[174] is based on the expectation that increased uncertainty more than proportionately increases the cost of the decision to delegate discretion to courts, as the uncertainty erodes natural constraints on judicial misuse of context and the incentive for moral hazard–based litigation. However, increasing the quality of the adjudicator can increase benefit relative to cost and thus shift the shape of the relationship between uncertainty and resort to context. In short, an expert court extends the range of uncertainty over which a standard-like fiduciary duty can operate effectively.

It is at this point that a collective decision to choose the same forum has an ironic impact: it allows the parties, by choosing the adjudicator, actually to reincarnate Llewellyn's concept of the merchant

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171 *See* Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value?: Antitakeover Protection in IPOs*, 17 J. L. ECON. & ORG. 83, 87 (2001).

172 *See, e.g.*, Leo E. Strine, Jr., *If Corporate Action is Lawful, Presumably There Are Circumstances in Which it is Equitable to Take That Action: The Implicit Corollary to the Rule of* Schnell v. Chris-Craft, 60 BUS. LAW. 877, 882 (2005) (describing Delaware's judiciary as being known for its "use of [the equitable principles of fiduciary duty] to restrain otherwise lawful conduct"). Those familiar with the common structure of chancery court opinions will recall that there is uniformly a lengthy and very detailed account of the facts—who negotiated with whom, what did they say, etc.—in cases that apply a fiduciary standard.

173 *See* Henry Hansmann, *Corporation and Contract*, 8 AM. L. & ECON. REV. 1, 14–17 (2006); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 845–47 (1995).

174 *See supra* Part III.B.5.

jury, the very judicial sensorium that had been eliminated from the U.C.C. To add irony to irony, the only judicially based interpretative regime that fully reflects Llewellyn's vision is not found in contract law but in Delaware corporate law where, coming full circle, the central player is a court of equity.

IV
Text and Context in Transactions with Legally Unsophisticated Parties

At the outset, we sharply distinguished between the application of doctrinal rules of contract interpretation to the contracts of legally sophisticated and legally unsophisticated parties.[175] With respect to the interpretation of legally sophisticated commercial contracts, we have argued that, properly understood, textualist interpretation does not prohibit resort to context by generalist courts in interpreting commercial contracts. Rather, textualist interpretation empowers contract design—the parties design interpretive regimes to prescribe the mixture of text and context that reflects the level of uncertainty and scale presented by their transaction. But legally unsophisticated parties by definition do not design contracts. Consumers, for example, play no role in the design of the contracts covering their transactions, and the parties who do design them may have exploitation of consumers as one of their goals. As we have seen, in important respects a central justification of a mandatory contextual interpretive regime is precisely to shift the contract design function from a legally unsophisticated individual to a generalist court, just the opposite of the appropriate interpretive regime for sophisticated commercial contracts.

Yet the application of a contextualist interpretive regime to consumer transactions makes the same mistake for these transactions as it did for legally sophisticated commercial contracts: it assigns the design function, and hence the choice of the best mix of text and context, to the wrong party. To be sure, a generalist court is better than empowering an exploitive contract designer, but we argue in this Part that a simple assignment of the contract design function in consumer transactions to a generalist court is also wrong. We show in Part IV.A that generalist courts standing alone are the least successful of the menu of public institutions that are capable of designing an interpretive regime to protect the rights of the consumer.

Consumers, however, are not the only parties who do not participate meaningfully in the design of their contracts. Neither do legally unsophisticated businesspersons—the archetypical vulnerable party, central to Llewellyn's thinking about contract interpretation, whom

175 *See supra* notes 4–9 and accompanying text.

we consider in Part IV.B. Like the consumer, these parties also do not carefully design their contracts, even if in a rote way they do choose the documents. In this setting, the application of a contextualist interpretive regime as a default rule, with an expert court acting to determine the context and to devise a complementary understanding of the parties' relationship, offers the promise of an effective interpretive regime. Unhappily, however, the available evidence suggests that assigning that task by default to a generalist court, as the law currently does, measurably increases the risk of judicial error.

A. An Interpretive Regime for Adhesion Contracts

Here we propose separating consumer contracts from the standard common law rules of interpretation designed for commercial parties by first acknowledging that commercial and consumer contracts are different and should be interpreted differently. We then relieve generalist courts of the burden of undertaking an unsupported empirical inquiry into context in connection with consumer contracts. We argue that it is a category mistake to treat the problem of exploitation in adhesion contracts[176] as a question of contract interpretation. The assumption that only a pure contextualist approach can protect the weak against the powerful—as Judge Traynor famously argued[177]—underlies the deep resistance of many scholars to the argument that sophisticated parties should be permitted to choose for themselves the answers to the questions of who decides when, and the extent to which, context is considered. But despite calls for common law contract rules that equip generalist courts with the tools to police consumer transactions, no such development has occurred.[178] One reason, surely, is that courts are peculiarly ill equipped to the task. We argue, therefore, for an interpretive regime that can draw lines between those transactions in which parties are free to choose their interpretive styles and those where mandatory regulation of terms is required to insure fair treatment.

The emerging interpretive regime in the EU offers many of the elements of a template for crafting a contract design process that separates agreements deserving special scrutiny from contracts between legally sophisticated parties. To safeguard consumers and to assure

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176 For the purposes of this Article, we define adhesion contracts broadly to include all contracts where one party is determined by appropriate state authority to be incapable of negotiating for contract terms that enhance its interests in the resulting agreement. That incapacity might be a function of information asymmetries, high coordination costs, severe imbalance in bargaining power, or the consequences of recognized cognitive biases.

177 *See supra* text accompanying notes 44–45.

178 *See* Robert A. Hillman, *The "New Conservatism" in Contract Law and the Process of Legal Change*, 40 B.C. L. REV. 879, 882 (1999); Ralph James Mooney, *The New Conceptualism in Contract Law*, 74 OR. L. REV. 1131, 1133–35 (1995).

the legal certainty on which commerce depends, the EU has chosen to separate contracts with consumers from the larger body of general contract law and to regulate consumer contracts through several directives harmonizing standards of consumer protection. The aim is to establish rules of commercial good conduct in settings in which consumers may be especially vulnerable to exploitation; to ban contract terms that serve only the interests of one party to the transaction; and to do this without affecting the contract law that generally governs agreements between commercial parties.

1. *The European Consumer Rights Directive and the Role of the Courts*

Within the EU single market, the fundamental problem of balancing protection of the contracting parties' freedom to arrange their own affairs and protection of the weaker party against imposition of lopsided bargains is exacerbated by interpretive diversity: the fact that private law relations "are to a significant extent still governed by national law," with the consequence that "the same type of [contractual] terms may even have different legal effects in different national legal systems."[179] Hence protections valid in one member state may be unrecognized in another, to the detriment of the consumer and to the common market to which the EU is dedicated. Consumer protection thus has been an abiding concern in the EU: "[T]here has been no other area in contract law which has been subject to so much EU legislative influence."[180] This has been addressed by crafting EU directives that focus on consumer contracts and so trump member state law.

A central element of the EU's consumer contract interpretive regime is the Directive on Unfair Terms in Consumer Contracts.[181] It aims to "facilitate the establishment of the internal market [and] also to ensure protection for individuals in their capacity as consumers when they purchase goods or services under a contract."[182] An annex to the directive contains a nonexhaustive, indicative, "grey" list of seventeen potentially unfair contract terms.[183] In order to capture be-

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179 A.G. Geelhoed, Opinion in Case C-237/02, Freiburger Kommunalbauten GmbH Baugesellschaft & Co. KG v. Ludger Hofstetter, 2004 E.C.R. I-3403, ¶ 30.

180 Norbert Reich, *A European Contract Law, or an EU Contract Law Regulation for Consumers?*, 28 J. CONSUMER POL. 383, 385 (2005).

181 *See* Council Directive 93/13/EEC, 1993 O.J. (L 095) 29–34.

182 A.G. Geelhoed, Opinion in Case C-478/99, Comm'n v. Sweden, 2002 E.C.R. I-4147, at ¶ 23.

183 The first five entries in the list are:

> (a) excluding or limiting the legal liability of a seller or supplier in the event of the death of a consumer or personal injury to the latter resulting from an act or omission of that seller or supplier;
>
> (b) inappropriately excluding or limiting the legal rights of the consumer vis-à-vis the seller or supplier or another party in the event of total or partial

havior beyond that which is specifically proscribed, a general clause in article 3(1) defines as unfair any contractual term, not individually negotiated, that "contrary to the requirement of good faith . . . causes a significant imbalance in the parties' rights and obligations arising under the contract, to the detriment of the consumer."[184] Similarly the Unfair Commercial Practices Directive includes an annex titled "Commercial Practices Which Are In All Circumstances Considered Unfair" to the consumer.[185] The Doorstep Selling Directive is another prominent example, addressing the element of surprise in contracts concluded away from the business premises of the trader, under circumstances where the consumer, not contemplating a purchase, may be caught off guard.[186] To mitigate the effect of sharp practices it ensures that the consumer has, and is properly notified of, a seven-day "cooling-off period," beginning with receipt of the notice, during which she has a right of withdrawal from the contract.[187]

Under EU law, responsibility for determining the unfairness of terms in particular consumer contracts falls primarily to the courts of member states, which can make use of the preliminary reference procedure to pose questions concerning the interpretation of EU law to the Court of Justice of the European Union.[188] For its part, the Court of Justice has generated a substantial body of case law in its efforts to reduce ambiguities arising from the unintended effects of the directives themselves.[189] Here, updating is required to protect the legiti-

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> non-performance or inadequate performance by the seller or supplier of any of the contractual obligations, including the option of offsetting a debt owed to the seller or supplier against any claim which the consumer may have against him;
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> (c) making an agreement binding on the consumer whereas provision of services by the seller or supplier is subject to a condition whose realization depends on his own will alone;
>
> (d) permitting the seller or supplier to retain sums paid by the consumer where the latter decides not to conclude or perform the contract, without providing for the consumer to receive compensation of an equivalent amount from the seller or supplier where the latter is the party cancelling the contract;
>
> (e) requiring any consumer who fails to fulfil his obligation to pay a disproportionately high sum in compensation.

Council Directive, *supra* note 181, Annex, at 33.

184 Council Directive, *supra* note 181, at 31.

185 Council Directive 2005/29/EC, Annex I, 2005 O.J. (L 149) 35–37.

186 Council Directive 85/577/EEC, 1985 O.J. (L 372) 31–33.

187 *Id.* at 31.

188 Consolidated Version of the Treaty on the Functioning of the European Union art. 267, Mar. 30, 2010, 2010 O.J. (C 83) 164.

189 One ambiguity concerns the rules of civil procedure. Member states' procedures that are unexceptionable in many domains may effectively block consumer access to courts under circumstances that strip consumers of the protections the directives would offer, and frustrate the statutory purpose. Thus in several cases national courts referred to the Court of Justice the question whether a clause conferring exclusive jurisdiction to the trader's legal domicile fell under the prohibition of terms having the effect of "excluding

mate interests of sellers. For example, permitting debtors to escape obligations that they assumed under impermissible conditions may create a moral hazard risk where debtors are able to escape legitimately incurred debts. Continuing evaluation of the secondary effects of the directives is needed to assure that they do not inadvertently create the very asymmetries in contractual relations they are designed to mitigate. Thus, the court has qualified statutory remedies to prevent opportunistic consumers from benefiting to the detriment of either other consumers[190] or the trader.[191] Where the court in the procedure-related cases based its intervention on the text of the directive, here it justified its insistence on balance or symmetry in the treatment of the parties on "general principles of civil law."[192]

These efforts notwithstanding, there are still important gaps in the EU regime for consumer contracts. The most significant is the absence of a comprehensive and reliable mechanism for updating the lists of prohibited contract terms provided in various directives. In part national courts can keep abreast of relevant changes in commercial practice simply by mutual monitoring of precedential decisions. But without a mechanism for more systematic, continuing review and updating there is the risk both that practices threatening consumer interests diffuse and take hold before they are clearly condemned, and that commerce is burdened by the enforcement of restrictions that have lost their relevance to consumer protection.[193]

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or hindering the consumer's right to take legal action or exercise any other remedy." *See* Joined Cases C-240/98 to C-244/98 Annex. Océano Grupo Editorial SA v. Roció Murciano Quintero, 2000 E.C.R. I-4941; Case C-243/08, Pannon GSM Zrt. v. Erzsébet Sustikné Gyorfi, 2009 E.C.R. I-4713; Case C-137/08, VB Pénzügyi Lízing Zrt. v. Ferenc Schneider, 2010 E.C.R. I-10888. The Court of Justice affirmed both the unfairness of the exclusive jurisdiction clause and the obligation of the national courts to consider the pertinence of the general prohibition in individual cases notwithstanding national procedural rules to the contrary. Similarly, the Court of Justice held that doorstep sellers who had not correctly informed consumers of their rights to withdraw from contracts could not then avail themselves of the expiration of the fourteen-day period for withdrawal as a defense against consumers who belatedly sought to exercise these rights. Case C-481/99, Georg Heininger v. Bayerische Hypo- und Vereinsbank AG, 2001 E.C.R. I-9965. By such decisions the Court of Justice is fashioning a European "consumer" process law aimed at safeguarding the purposes of the directives.

190 Case C-215/08, E. Friz GmbH v. Carsten von der Heyden, 2010 E.C.R. I-2947.

191 Case C-412/06, Annelore Hamilton v. Volksbank Filder eG, 2008 E.C.R. I-2383.

192 *Id.* For some background, see Stephen Weatherill, Note, *The 'Principles of Civil Law' as a Basis for Interpreting the Legislative Acquis*, 6 EUR. REV. CONT. L. 74, 74–77 (2010).

193 Aware of the need to take account of the evolution of unfair practices and also to protect merchants against excessive regulation, the EU in 2008 incorporated a sophisticated updating mechanism into a proposed revision of Council Directive 93/13/EEC, *supra* note 181, and its consolidation with three other directives into a single instrument on consumer contractual rights. Terms used in particular contracts that are perceived as potentially unfair by a court in a member state may be referred to a standing body of experts, nominated by the member states and chaired by an official of the EU Commission. This body would then have decided (subject to override by the European Parliament and the

In sum, under the current regime the national courts of the member states play a quasi-administrative function—drawing the attention of home-state regulators to possibly unfair terms. In turn, the Court of Justice acts as a judicial backstop, correcting procedural limitations and unintended consequences of the protective framework. The overall effect is to protect consumers, and by extension other vulnerable parties, obligating member states to do a "spring cleaning"[194] of their consumer-protection regimes to ensure conformity with the developing principles of EU law, yet (by reserving application of those principles to national courts) not unduly unsettling the surrounding body of national contract doctrine.[195] Such an interpretive regime differs from conventional adjudication in treating each case not only as a matter of fairness to an individual claimant, but as a potential indication of systemic failure and an opportunity for improvement that applies broadly to all consumers in the particular market. By es-

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European Council) whether the challenged term is to be added to the black list of prohibited terms established by Council Directive 93/13/EEC, a new grey list of suspect transaction forms, or, eventually, promoted from the grey to the black list or removed from both. This mechanism would have enlisted courts in the task of updating the register of impermissible terms without empowering the judiciary to routinely question the express meaning of agreements in a way that undercuts the autonomy of sophisticated commercial parties to design contracts free from such regulation.

But resistance—by the European Parliament to the committee updating procedure and by consumer groups against corresponding limitations on the right of member states to supplement EU consumer protections without securing broad approval—doomed this proposal. Instead, the Consumer Rights Directive of 2010 merely synthesizes the two directives on off-premises and on distance contracts. It includes no updating mechanism.

> Admittedly, most Committee Members and stakeholders seem to agree with the aim of harmonising the general clause on unfair contract terms, while insisting that further assessment is needed. But it is widely believed that black and grey lists of unfair contract terms should not be harmonised at this stage in order to avoid negative consequences (deletion of terms from existing national lists, reduction of the level of legal certainty triggering a litigation wave throughout the EU, lack of flexibility etc.). There is consensus that Member States could keep their own lists of unfair contract terms provided they are consistent with the general clause and Internal Market rules.
>
> It should however be possible to ban a limited number of unfair contract terms at EU level and guarantee that Member States cannot maintain or adopt diverging national provisions in this relatively narrowly harmonised field. In the light of the principle of full democratic control of the European Parliament, the Commission's proposal to ban additional unfair terms through Comitology seems at this point not to constitute the preferred approach. The new provisions regarding Comitology in the Lisbon Treaty have to be assessed carefully before deciding on this matter.

EUR. PARL. DOC. (COM 2008 614/3-2008/0196 (COD)) 7 (2008), *available at* http://www.europarl.europa.eu/sides/getDoc.do?pubRef%2F%2FEP%2F%2FNONSGML%2BCOMPARL%2BPE-439.177%2B02%2BDOC%2BWORD%2BV0%2F%2FEN.

194 Hugh Collins, *Harmonisation by Example: European Laws against Unfair Commercial Practices*, 73 MODERN L. REV. 89, 92 (2010).

195 For discussion of this "multi-level"—EU and member state—process, see HUGH COLLINS, THE EUROPEAN CIVIL CODE: THE WAY FORWARD 182–209 (2008).

tablishing a similar quasi-administrative regime through appropriate state or federal legislation, American contract law could accomplish two critically important goals: first, to more effectively and appropriately regulate non-negotiated consumer transactions; and, second, to free sophisticated commercial parties from constraints that are inapt to their circumstances.

2. *A Common Law Adaptation of the European Model*

Consumer-oriented interpretive regimes of this sort also can be found in U.S. law. Insurance law is a longstanding example, which also exhibits flaws and failures over its history. After a long period in which generalist judges modified common law doctrines to create, in effect, a special contract law for insurance, courts responded to the broad revival of textualist interpretation in recent decades by undermining the very doctrinal structure they had created. But this failure does not seem to reflect any limit of the common law; rather, as in the case of EU consumer rights, it points to the need for a stabilizing conception of the relation between generalist courts and the interpretive regime.

The provision of insurance is highly regulated by the states to balance the need to safeguard the solvency of insurers with the requirement of broad accessibility of coverage to consumers on fair terms. To assure adequate risk pooling and reduce the effects of adverse selection, coverage of certain types of insurance is mandatory. Thus, all states have compulsory automobile liability insurance in some form. To ensure actuarial precision, moreover, terms specifying the conditions of coverage have to be standardized by statute or regulation across the risk pool, so consumers desiring a particular type of coverage must accept the terms of the industry standard. The 1943 New York Standard Fire Insurance Policy, for example, is used in nearly every state and incorporated into the standard homeowner's policy.[196] To underscore the extreme limitations on consumer choice in this domain, agreements between insurers and insured have been called "super-adhesion" contracts.[197]

In view of pervasive regulation and standardization of insurance, and the resulting restrictions on the consumer's capacity to bargain over terms, courts from roughly the 1960s through the end of the 1980s modified general rules of contract to reach decisions protecting consumer interests while also creating incentives for insurers and reg-

196 Susan Randall, *Freedom of Contract in Insurance*, 14 CONN. INS. L.J. 107, 130 (2007).

197 Roger O. Steggerda, Note, *Watching Your Neighbor's Child: Is Babysitting Really a Business Pursuit?: A Comment on* Dwello v. American Reliance Insurance Company, 1 NEV. L.J. 323, 324 n.14 (2001) (citing JEFFREY W. STEMPEL, LAW OF INSURANCE CONTRACT DISPUTES § 4.06[b], at 4–37).

ulators to clarify and strengthen the overall regime.[198] One of the most important adjustments of general doctrine was the elaboration of a strong variant of *contra proferentem*, under which a court encountering an ambiguity in an agreement immediately decides for the policyholder rather than undertaking the usual efforts to determine the parties' meaning.[199] Another was judicial defense of the policyholder's reasonable expectations of coverage, explicit language in the agreement notwithstanding.[200] As Professor Robert Keeton summarized the doctrine over forty years ago: "The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations."[201] Had courts applied these doctrines with consistent rigor, and had insurers and regulators responded in kind by updating policy forms in response to the continuing dialogue with courts, the result would likely have been an ongoing clarification and updating of what counts as an unambiguous policy term, and what expectations of insurance coverage policyholders may reasonably have.[202]

Unhappily, the courts' inconsistent protection of reasonable expectations and their embrace of interpretive rules drawn from common law contract principles undercut both that doctrine and the strong form of *contra proferentem*. Moreover, the courts' fitful oversight of regulators—despite clear authority to hold them to account—and, most generally, their lack of understanding of the judiciary's role in the emergent constellation of insurance law, contributed significantly, perhaps decisively, to the disorganization of what had been an emergent special-purpose interpretive regime.

This pattern can be seen in the trajectory of the application of reasonable expectations doctrine to insurance contracts. The appeal, but also the limit, of reasonable expectations as a standalone special-purpose insurance contract doctrine was its generality. The doctrine, a creature of the common law, can be applied beyond insurance[203] to

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198 *See* Randall, *supra* note 196, at 109–11.

199 *See id.*

200 *See id.* at 111–18.

201 Robert E. Keeton, *Insurance Law Rights as Variance with Policy Provisions*, 83 HARV. L. REV. 961, 970 (1970).

202 The regulators' contribution to maintenance of the interpretive regime was no doubt limited by industry capture of their national association, the National Association of Insurance Commissioners (NAIC). In recent years approximately half of NAIC's revenues come from fees assessed on companies in proportion to the volume of the policies they write, while less than five percent come from fees assessed by the states. Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U. L. REV. 625, 639 (1999).

203 *See* Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151, 1181–82 (1981); *see also* Ethan J. Leib, *What is the Relational Theory of Consumer Form Contract?*, *in* REVISITING THE CONTRACTS SCHOL-

the vast majority of adhesion contracts to which consumers consent in mass-market settings. Indeed, at least one state has already extended the reasonable expectations doctrine broadly to reach all standard-form consumer contracts,[204] and scholars have generally conceded that "the doctrine also lacks any principled justification for being limited to insurance policies."[205] But as the doctrine became untethered from its original setting in insurance, and as that setting itself changed in ways that generalist judges could not themselves directly register, the attractive indeterminacy of the reasonable expectations model in the setting of an ongoing dialogue between courts and regulators led to unpredictable decisions ("[t]he opinions speak of expectations without satisfactorily pointing to their source"[206]) and judicial error—the costs of which have arguably been borne by consumers in the form of higher premiums.[207] Thus, many courts have been reluctant to apply the doctrine except in cases of egregious abuse, and when it is applied it has been the subject of sustained scholarly criticism.[208]

Generalist courts have consequently abandoned the understanding of reasonable expectations as a mandate to evaluate the conformity of an agreement to the larger goals of insurance policy regardless of the clarity of the contractual language; instead they apply the doctrine to resolve residual ambiguity. As the Supreme Court of West Virginia recently put it: "[I]n West Virginia, the doctrine of reasonable expectations is limited to those instances . . . in which the policy language is ambiguous. This Court has explained that [t]he doctrine of reasonable expectations is essentially a rule of construction, and unambiguous contracts do not require construction by the courts."[209]

With regard to *contra proferentem*, generalist courts have reverted in insurance cases to traditional, general contract doctrine. This turns the doctrine (back) into a rule of last resort, to be applied against the drafter only after the usual interpretive means of ascertaining the parties' intent have failed. The upshot is that the insurance law regime adumbrated by Professor Keeton is in disarray.

ARSHIP OF STEWART MACAULAY 259 (Jean Braucher, John Kidwell & William C. Whitford eds., 2013).

204 *See* Kloss v. Edward D. Jones & Co., 54 P.3d 1, 7 (Mont. 2002).

205 W. David Slawson, *The New Meaning of Contract: The Transformation of Contracts Law by Standard Forms*, 46 U. PITT. L. REV. 21, 52 (1985).

206 Abraham, *supra* note 203, at 1163.

207 *See* Susan M. Popik & Carol D. Quackenbos, *Reasonable Expectations after Thirty Years: A Failed Doctrine*, 5 CONN. INS. L.J. 425, 431–32 (1999).

208 *See id.*; Mark C. Rahdert, *Reasonable Expectations Revisited*, 5 CONN. INS. L.J. 107, 113–15 (1999); Stephen J. Ware, *A Critique of the Reasonable Expectations Doctrine*, 56 U. CHI. L. REV. 1461, 1492 (1989).

209 Jenkins v. State Farm Mut. Auto. Ins. Co., 632 S.E.2d 346, 352 (W.V. 2006) (internal quotation marks and citations omitted).

This outcome might have been avoided if courts, instead of reimposing general contract doctrines, had instead used their power of administrative review to induce regulators to seek clarification of insurance terms and policies. In that case the doctrinal adjustments would have functioned as a judicially administered incentive system—rewarding clarity achieved by the parties under the regulator's aegis, and penalizing failure to achieve this result—rather than as an open-ended invitation to judges themselves to determine in particular cases what the parties ought to have intended. For instance, some codes obligate the insurance commissioner to disallow a policy form containing or incorporating by reference ambiguous or misleading clauses; similar statutes mandate disapproval of a form whose provisions are unfair, inequitable, or contrary to the state's public policy. Instead of entering into this dialogue with regulators, generalist courts preferred to defer to the pro forma decisions of regulators, and treat their assent to forms and policies as an expression of legislative will, binding the judiciary and the parties to eventual contracts.[210]

It may be possible to apply the lessons of the EU example and the rise and decline of the insurance contract law regime to the construction of a consumer contract regime in the United States even in the absence of encompassing legislation to that effect. For example, considerable authority to regulate terms in consumer contracts is currently embodied in legislation creating the Consumer Financial Protection Bureau as well as in the authority of the Federal Trade Commission to regulate "unfair trade practices."[211] As the preceding

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210 *See* Randall, *supra* note 196, at 138.

211 The official website of the Consumer Financial Protection Bureau (CFPB) describes this project in the following terms:

> The Consumer Financial Protection Bureau will aim to bring clarity to the marketplace. A fair, efficient, and transparent market depends upon consumers' ability to compare the costs, benefits, and risks of different products effectively and to use that information to choose the product that is best for them. Fine print and overly long agreements can make it difficult for consumers to understand and compare products, and that obstacle to sound markets is not removed by disclosures that are too complicated or that do not focus on the key information consumers need. The principal role of consumer protection regulation in credit markets is to make it easy for consumers to see what they are getting and to compare one product with another, so that markets can function effectively.
>
> . . .
>
> The Bureau already has been hard at work attempting to make clarity a reality. Early efforts have focused on mortgages and credit cards, but those are not the only areas in which the Bureau has made progress.
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> . . .
>
> The CFPB began testing two alternate prototype forms that are designed to be given to consumers who have just applied for [credit]. This testing—which will continue in the coming months and involve one-on-one interviews with consumers, lenders, and brokers—will precede and inform the CFPB's formal rulemaking process. The CFPB also has posted the proto-

discussion suggests, the baseline establishing the expectations that are "reasonable" in any given market cannot come from generalist courts. The information needed to answer this question can, however, be developed through the rulemaking process of administrative agencies charged with the task of regulating transactions in particular markets and sharpened though interaction with the courts, both in judicial review of them and in their application.

A particularly salient example of just such a process is the recent action by the Consumer Financial Protection Bureau in issuing a model "plain language" form for credit card contracts.[212] Importantly, use of the model form is not mandatory for banks and other entities that extend credit to consumers. Rather, the use of a model form provides a safe harbor for creditors or lessors.[213] Thus, it is conceived as a default from which the regulated entities may depart at their option. The objective, then, is not to impose the terms and conditions of credit card contracts but rather to provide a baseline of "reasonable expectations" against which existing practices can be measured. This is the empirical question that courts have been unable to answer successfully in the insurance context. What a generalist court can do better, however, is to assess the facts in individual disputes and measure the distance between the baseline and the contractual terms and conditions in the disputed contract. By engaging in this more limited role, over time a jurisprudence of legally significant deviations from the baseline will emerge. That experience, in turn, would provide the updating mechanism that permits the relevant agency to revise the baseline in light of the new information revealed in litigation. In this way, the underlying empirical realities can be revised to better balance the interests of both the merchant seller and the class of consumers in the particular market being regulated.[214]

> types on its website with an interactive tool to gather public input about the designs.
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> . . .
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> The testing and public feedback process will enable the CFPB to revise the design and refine the content based on how it works for consumers. Two rounds of feedback and revision have occurred so far. In the first round, the Bureau received 13,096 comments on the two initial versions of the new disclosure form.

CONSUMER FIN. PROT. BUREAU, BUILDING THE CFPB: A PROGRESS REPORT 10–11 (2011), *available at* http://files.consumerfinance.gov/f/2011/07/Report_BuildingTheCfpb1.pdf.

212 *See Integrated Mortgage Disclosures Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth In Lending Act (Regulation Z)*, CONSUMER FIN. PROT. BUREAU, http://www.consumerfinance.gov/regulations/integrated-mortgage-disclosures-under-the-real-estate-settlement-procedures-act-regulation-x-and-the-truth-in-lending-act-regulation-z/.

213 *See* 15 U.S.C. § 1604(b) (2006) ("A creditor or lessor shall be deemed to be in compliance with the disclosure provisions . . . if the creditor or lessor . . . uses any appropriate model form or clause as published by the [CFPB].").

214 In addition, the CFPB urges firms subject to its rules to develop implementation plans, starting with a "gap analysis to determine what business, operational, and automated

The model credit card standard form is not an isolated example of how a consumer contract regime can emerge. The use of model terms and conditions as baselines for litigation under the doctrine of reasonable expectations is an interpretive strategy that easily can be adopted by other interpretive bodies, in particular the Federal Trade Commission, that deploy their rule-making authority to develop the empirical foundation of the standards for fair contracting in other markets with similar characteristics.[215]

B. Design Choices and Interpretive Regimes for Legally Unsophisticated Commercial Parties

We now consider a different group of contracting parties who, like consumers, have been said to be especially in need of assistance by generalist courts through contextualist interpretation, but for starkly different reasons. This is the world of small business, whose participants were of special concern to Karl Llewellyn. These parties are sophisticated with respect to their businesses; however, they choose legally unsophisticated contractual arrangements. The amount of money at stake in a single transaction typically is too small to warrant bespoke contracting to create an interpretive regime that a textualist court should respect. Nor are dealings homogenous enough to motivate creation of a detailed industry code and dispute resolution system. Hence these parties are drawn to standardized and prefabricated contracting documents, such as invoices, purchase orders, and acknowledgment forms. This is the realm, for example, of the dueling forms problem: where one party's invitation to a counterparty to enter a transaction is reflected in one form with attendant boilerplate, while the counterparty agrees to participate through transmittal of a different form whose attendant boilerplate differs from the first form in a fashion that turns out to be significant

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transaction processes need to change as a result of the new rules[,]" and including procedures for responding to implementation delays, for detecting and correcting infractions of the new routines, and for keeping senior management and boards abreast of developments. Operation of such a (self-correcting) compliance system will mitigate liability for eventual rule violations. CONSUMER FIN. PROT. BUREAU, 2013 CFPB DODD-FRANK MORTGAGE RULES READINESS GUIDE (2013), *available at* http://files.consumerfinance.gov/f/201307_cfpb_mortgage-implementation-readiness-guide.pdf; CONSUMER FIN. PROT. BUREAU, SUPERVISORY HIGHLIGHTS: SUMMER 2013 (2013), *available at* http://files.consumerfinance.gov/f/201308_cfpb_supervisory-highlights_august.pdf; CONSUMER FIN. PROT. BUREAU, CFPB Bulletin 2013-06: Responsible Business Conduct: Self-Policing, Self-Reporting, Remediation, and Cooperation (June 25, 2013), *available at* http://files.consumerfinance.gov/f/201306_cfpb_bulletin_responsible-conduct.pdf.

215 For a similar suggestion, using the Federal Trade Commission to provide the empirical basis for identifying fair terms in consumer contracts, see Ian Ayres & Alan Schwartz, *The No-Reading Problem in Consumer Contract Law*, 66 STAN. L. REV. 545, 579–94 (2014).

ex post.[216] In this realm, moreover, as Llewellyn stressed and Stewart Macaulay later corroborated,[217] relationships are often longstanding and depend importantly on custom, practice, and past course of dealings.[218] Under these conditions it is for generalist courts to determine applicable standards in resolving disputes.

We consider first the more common case in which legally unsophisticated commercial contracting parties are poorly served by standardized contracts inviting contextualization by generalist courts because, lacking the requisite specialization, such courts will be relatively ineffective at deriving context through the limited sources of information available in litigation. The result is a higher incidence of mistakes, increasing the attraction of informal resolutions compared to formal resolution. From this perspective, small business patterns of relational contracting described by Macaulay flow not only from the cost of judicial resolution but also from its poor performance.

We then turn to the exceptional outcomes in which a particular court will have the favorable attributes we have ascribed to early courts of equity—a deep knowledge of the local community and of the businesses that come before it—resulting often from geographical concentration of industry and therefore cases.[219] Such a match between local courts and local industry provides an effective legal infrastructure for an industrial district;[220] in effect, we see a naturally occurring interpretive or epistemic community. In this circumstance, the generalist court acquires the expertise to well serve its litigants—in this regard, it becomes a specialist.

Two examples illustrate the range of conditions favoring this exceptional outcome. The first, introduced above, is the Delaware Chancery Court, a virtual industrial district that allows geographically dispersed companies to concentrate for purposes of applicable legal rules and dispute resolution.[221] The second is the Santa Clara County Superior Court, which is the California trial court for much of Silicon Valley. Unlike the Delaware Chancery Court, the Santa Clara County

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216 For discussion, see SCOTT & KRAUS, *supra* note 41, at 248–78.

217 *See* Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 56–62 (1963).

218 For discussion of Llewellyn's views on custom, see Scott, *supra* note 43, at 1037–41; see also U.C.C. § 2-202 cmt. 2 (2014) ("[W]ritings are to be read on the assumption that the course of prior dealings between the parties and the usages of trade were taken for granted when the document was phrased. . . . Similarly, the course of actual performance by the parties is considered the best indication of what they intended the writing to mean.").

219 *See supra* note 173 and accompanying text.

220 *See* Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*, 74 N.Y.U. L. REV. 575, 578 (1999) (describing the role of law in supporting industrial districts).

221 *See supra* Part III.C.3.

Superior Court is generalist in terms of jurisdiction but is specialized as a result of geographic industrial concentration (rather than the virtual concentration observed in Delaware).[222] In these circumstances, a generalist court is effective because its ongoing dealings with a particular kind of business may result in specialized expertise.

1. *Interpretation of Commercial Contracts Without Ex Ante Design: The Costs of Using Generalist Courts*

Legally unsophisticated commercial parties—the paradigmatic sales transactions formed by the exchange of standard-form documents and highlighted by the potential for conflicts between the (dueling) forms—are the primary focus of concern in this section. A textualist emphasis on the use of merger clauses and plain meaning interpretation, instead of empowering these parties to actively design their contract, may force them into an unwanted textualist regime from which they can opt out only at great cost: the individual transactions can be expected to be too small and to move too quickly to make costly bespoke contracting feasible. The problem is not that the parties are unsophisticated about the subject of their contracting. Rather, these contracts reflect typically short-term interactions. Circumstances change between each iteration, and a bespoke contract that seeks to address anticipated but not predictable changes in specifications, quantity, and price, is well beyond the parties' capacities to craft without an investment that is not feasible given the size of the contract. A bespoke contract that speaks to only a single transaction would have to be adjusted, at daunting drafting costs, to then-current circumstances with each iteration lest in a textualist regime the court will apply terms that no longer fit. Moreover, the costs of such adjustment are also high with respect to the time involved to negotiate and renegotiate the contract. As Patrick Bolton has shown, the cost of delay when commercial circumstances make speed important raises the price of the reduced uncertainty associated with ex ante contract design.[223]

As we have seen, the cost of updating to reflect changing conditions is not burdensome when the scale of the type of contracting supports the development of an interpretive regime that collectivizes both the updating of contract terms and their interpretation. The problem in this category of legally unsophisticated commercial con-

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222 *See* John Armour, Bernard Black & Brian Cheffins, *Delaware's Balancing Act*, 87 IND. L.J. 1345, 1397 (2012) (describing how "many corporate suits are brought in . . . the Santa Clara County Superior Court. . . [which] has correspondingly developed considerable familiarity with corporate cases").

223 *See* Patrick Bolton & Antoine Faure-Grimaud, *Satisficing Contracts*, 77 REV. ECON. STUD. 937, 948–49, 964 (2010).

tracting, however, is that the number of parties, their relatively small size, and the idiosyncrasies of their dealings, makes the development of an interpretive community of the sort we have examined elsewhere, such as the cotton market, infeasible.[224]

But courts applying contextual interpretation to these legally unsophisticated parties in areas of geographic concentration of similar contracting parties can develop both judicial expertise in the subject matter and a body of precedents that can parallel private interpretive regimes.[225] In effect, in instances such as the Delaware Court of Chancery and perhaps the Santa Clara County Superior Court with respect to the Silicon Valley industrial district, we see a type of interpretive regime developing in a form that reflects both the constraints imposed by the problems of uncertainty and scale that prevent recourse to either bespoke contracting or a collective interpretive regime, and the potential that generalist courts may become specialist courts through repeated exposure to the particular industry. It is the potential for this form of naturally occurring, judicially based interpretive regime that may have underlain Llewellyn's willingness to accept the Uniform Commercial Code's mandatory contextual interpretation despite the rejection of the merchant jury. Under these circumstances, a generalist court applying contextualist interpretation can well serve a geographic concentration of similar contracting parties—the judicial element of a Marshallian industrial district.

But what is the fate of legally unsophisticated parties who lack the scale to create private interpretive regimes and where the levels of commercial concentration cannot produce judicial expertise and specialization? Here the trigger to textualist interpretation (a merger or integration clause or a facially complete contract) is unlikely to be present in many cases, and so these parties remain subject to the default contextualist interpretive style. Absent the kind of concentration that allows a generalist court to build knowledge and expertise, and given the lack of scale and the barriers of cost, generalist courts will be the only formal—although ineffective—method of dispute resolution, but the risk of mistake resulting from lack of specialized experience

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224 For a discussion of the interpretive regime that regulates disputes in the cotton market, see Gilson, Sabel & Scott, *supra* note 13, at 202–05.

225 For discussion of these "network externalities," see Klausner, *supra* note 173, at 772–825; Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "the Economics of Boilerplate")*, 83 VA. L. REV. 713, 729–40 (1997). For example, consider the negotiation of an acquisition agreement when the acquiring company has a short exclusivity period during which the target company will not entertain competing bids. In this circumstance, the delay associated with negotiating bespoke, precise terms may impose high costs not through legal fees to draft them but through the loss of valuable time to get a deal done within the exclusivity period.

will push the parties toward informal methods. In those circumstances, where general courts applying contextual interpretation will perform least well, we would expect they would be resorted to less frequently.[226]

The heightened risk of error by a generalist court seeking the relevant contractual context is a function of two core problems. The first is the growing evidence that, even in a stable world, custom and practice do not tend toward the kind of equilibria that can be captured in a rule, and that in a world of uncertainty even such jittery constancy as exists in commercial practice in quiet environments is constantly changing in response to exogenous and endogenous factors.[227] In short, there may not be any stable custom or usage for the court to find as a fact as the legal doctrine currently assumes can be done.[228] While intimate familiarity with the evolving commercial practice may permit an expert court, such as the Delaware Court of Chancery, to reliably recover the always evolving contextual facts needed to resolve fiduciary duty disputes, generalist courts are denied access to such specialized knowledge. Second, and perhaps for the foregoing reasons, there is growing evidence that generalist courts do not even try to find the relevant custom and usages. This evidence suggests that many courts, lacking expertise, rely on interested party testimony and unsupported assumptions of reasonable commercial behavior rather than a careful evaluation of complex evidentiary submissions.[229]

There is some modest evidence that generalist courts are beginning to shape legal doctrine in response to the heightened risk of error in unfocused explorations of context. For example, under New York law a court is permitted under limited circumstances to allow use of context evidence to show that language that appears to have a plain meaning in fact has a different trade usage, even where the trigger to textualism is otherwise met.[230] But here, the courts limit the breadth

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226 *See generally* Iva Bozovic & Gillian K. Hadfield, *Scaffolding: Using Formal Contracts to Build Informal Relations in Support of Innovation* (Univ. of S. Cal. Law & Econ. Research Paper, No. C12-3, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1984915 (studying interpretive structures through interviews with a group of firms that use formal contracts only to reinforce informal modes of enforcement).

227 *See* Bernstein, *Private Commercial Law in the Cotton Industry*, *supra* note 160, at 1743–44, 1775–76 (discussing the interaction of exogenous factors and endogenous shading responses by the parties).

228 Craswell, *supra* note 20, at 118.

229 Bernstein, Trade Usage in the Courts, *supra* note 18, at 14–18.

230 *See* Law Debenture Trust Co. v. Maverick Tube Corp., 595 F.3d 458, 465–68 (2d Cir. 2010); British Int'l Ins. Co. v. Seguros La Republica, S.A., 342 F.3d 78, 84 (2d Cir. 2003) (stating that "the advocate of the trade usage must establish either that the party sought to be bound was aware of the custom, or that the custom's existence was 'so notorious' that it should have been aware of it" (quoting Reuters Ltd. v. Dow Jones Telerate, Inc., 662 N.Y.S.2d 450, 454 (1st Dep't 1997))). This limited incursion on the plain meaning rule is

of any ex post resort to context. To defeat the grant of summary judgment in favor of a party relying on the plain meaning of contractual terms, the court in effect requires the equivalent of trade association specifications. The party urging that terms have a specialized industry meaning must meet a very high standard to avoid summary judgment: "[P]roof of custom and usage consists of proof that the language in question is 'fixed and invariable' in the industry in question."[231] The trade usage must be "'so well settled, so uniformly acted upon, and so long continued as to raise a fair presumption that it was known to both contracting parties and that they contracted in reference thereto.'"[232] For our purposes, note the safety valve that releases contextualist interpretation explicitly looks to the central characteristic of an industrial district: scale, with the actions of many small contracting parties giving rise to the clear patterns of meaning that Llewellyn had in mind.[233]

In sum, smaller parties who sensibly, albeit sometimes intuitively rather than analytically, reject an invitation to engage in contract design likely will confront courts considering context ex post, a form of interpretive regime that fits the parties' contracting conditions. For

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also available to sophisticated commercial parties. *See Law Debenture Trust*, 595 F.3d at 471–72 (addressing the question of whether the term "common stock" included arguably functionally similar American depositary receipts).

231 *Law Debenture Trust*, 595 F.3d at 466 (quoting Hutner v. Greene, 734 F.2d 896, 900 (2d Cir. 1984) (quoting Belasco Theatre Corp. v. Jelin Prods., Inc., 59 N.Y.S.2d 42, 45 (App. Div. 1945))). *Belasco* goes on to state that "[a] custom, in order to become part of a contract, must be so far established and so far known to the parties, that it must be supposed that their contract was made in reference to it. For this purpose the custom must be established, and not casual, uniform and not varying, general and not personal, and known to the parties." *Belasco*, 59 N.Y.S.2d at 46 (quoting Sipperly v. Stewart, 50 Barb. 62 (1867)).

232 *Law Debenture Trust*, 595 F.3d at 466 (quoting *Seguros La Republica*, 342 F.3d at 84 (quoting *Reuters*, 662 N.Y.S.2d at 454)).

233 A final category of legally unsophisticated commercial parties involve transactions where the parties mistakenly use standard forms that on their face reflect a textualist design choice, manifested by a merger clause and a hard parol evidence rule, and so trigger textualist interpretation (and where observable industry standards as just described do not provide a way out). Here there is a real question of whether the category includes meaningful numbers of contracting parties, and whether providing recourse to context actually would help these firms. We are skeptical that there are significant numbers of smaller business entities that use form contracts containing a merger or integration clause without in fact knowing what they are doing; rather, the large majority of firms fall in the first category where uncertainty and scale lead to contracts to which either textualist interpretation would not apply or, subject to a high standard of proof, resort to industry standards is still possible. Moreover, even with respect to the number of parties that do misuse standard-form documents, we believe that contextualist interpretation by a generalist court absent geographical concentration is likely to yield even worse results. In this setting, the court confronts what is basically a standard-form contract. The generalist court has no guidance concerning what context is relevant other than the parties' instrumental assertions at the time of litigation. Thus, the likelihood of moral hazard inducing error is high. As a result, contracting parties will have an incentive to develop relational-based contracting, as Macaulay, *supra* note 217, describes, because a generalist court will be error prone.

these parties, the resulting increase in back-end enforcement costs is preferable to the alternative of incurring the even larger increase in the front-end costs of ex ante design. And in those circumstances where courts do not have the specialized local knowledge of the early courts of equity, we can expect the parties to minimize the role of inexperienced generalist courts by relying more heavily on relationally based enforcement.

2. *The Return of Equity: Expert Courts as Interpretive Regimes*

While LLCs and other organizational forms like limited partnerships are used by legally sophisticated parties as both the basis for large private equity and venture capital funds and in some cases as a vehicle for public investment,[234] a very large number of privately held businesses whose participants are legally unsophisticated contract with each other over the terms of their organizational relationship through the corporation's articles of incorporation or, for LLCs, through the operating agreement.[235] As we will see, judicial specialization appropriately addresses the interpretive problem associated with the contract design that establishes an organization.

Situating the relationship of the corporate law of small privately held corporations within contending interpretive approaches in contract law requires a little history. The attraction of corporate organization to small business people is that the corporate form typically will shield shareholder-owners from personal liability for the debts of the corporation whether in tort or contract.[236] But what governs the relations among the participants in the corporation? Typically, the "form" contract was reflected in the corporation's articles of incorpo-

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234 *See* Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 567 (2012) (describing sample of publicly traded limited partnerships and LLCs).

235 Ann E. Conaway, *Lessons to be Learned: How the Policy of Freedom to Contract in Delaware's Alternative Entity Law Might Inform Delaware's General Corporation Law*, 33 DEL. J. CORP. L. 789, 801–02 (2008). In Delaware, for example, from 2005 through 2009, the number of LLCs created exceeded the number of ordinary corporations created from 256% to 313%, and since 1992 when the Delaware LLC statute was adopted, more LLCs were created than all other types of business entities combined. Mohsen Manesh, *Delaware and the Market for LLC Law: A Theory of Contractibility and Legal Indeterminacy*, 52 B.C. L. REV. 189, 200 (2011). The growth in LLCs relative to other organizational forms is not limited to Delaware. *See* Rodney D. Chrisman, *LLCs are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States between 2004–2007 and How LLCs were Taxed for Tax Years 2002–2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 459–60 (2010) (finding that the formation of new LLCs outpaces the formation of new corporations nationwide by a nearly 2-to-1 margin).

236 *See e.g.*, Martin Petrin, *The Curious Case of Directors' and Officers' Liability for Supervision and Management: Exploring the Intersection of Corporate and Tort Law*, 59 AM. U. L. REV. 1661, 1696 (2010) ("[T]he principle of limited liability[ ] . . . restricts shareholders' personal liability for the debts and liabilities of the corporation to the extent of their investment and insulates corporate agents from contractual claims.").

ration and bylaws, and sometimes in a shareholders' agreement. As with smaller commercial parties contracting among themselves directly, these owners often did not address the range of state contingencies that might leave some of the owners subject to opportunistic behavior as facts replaced expectations with the passage of time.[237] A standard pattern was that a controlling owner and a minority owner would extract the return on their investment through their employment by the corporation. Subsequently, the controlling shareholder used standard corporate law rules to terminate the employment of the minority owner and so drastically reduced the value of the minority stake.[238]

In general, courts responded to these smaller-scale intra-corporate contracting issues through the application of a broad standard and the resulting contextual interpretation. This was accomplished in close corporations by the proposition that shareholders in a close corporation owed each other a fiduciary duty, whose measure was the shareholders' "reasonable expectations" determined through the court's parsing of the testimony.[239] What remained unclear in this parallel contractual regime is whether the use of a broad standard of contextual interpretation was a default or, as in the case of the general contextualist position, mandatory.

Recent events in Delaware provide a nice account of this tension. In 1993, Delaware rejected the position, commonplace in other jurisdictions, that shareholders in a close corporation owed each other a special fiduciary duty measured by entire fairness.[240] However, Delaware also treats general fiduciary duty in corporations, as opposed to a special close-corporation fiduciary duty, as mandatory and not subject to waiver.[241] This outcome, though, does not extend to alternative forms of entities, like limited partnerships and LLCs. A series of statutes and court decisions resulted in the clear position that Delaware

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237 The drafting costs, which are significant given the small scale of the businesses of concern here, are made worse by the issue of whether a single lawyer can address both parties in negotiating the corporate documents or operating agreements given that the parties will have conflicting interests along some dimensions. For example, California Rule of Professional Conduct 3-310(C) requires a lawyer to secure "informed consent" of each person when she represents all of the parties forming a small business. CAL. RULES OF PROF'L CONDUCT R. 3-310(C) (2008). New York Rule of Professional Conduct 1.7 is to similar effect. *See* N.Y. RULES OF PROF'L CONDUCT R. 1.7 (2009).

238 *See, e.g.*, Donahue v. Rodd Electrotype Co., 328 N.E. 2d 505, 513–15 (Mass. 1975) (describing how majority stockholders attempt "freeze-outs" to oppress or disadvantage minority stockholders).

239 *See* JESSE H. CHOPER, JOHN C. COFFEE, JR. & RONALD J. GILSON, CASES AND MATERIALS ON CORPORATIONS 790–96 (8th ed. 2013) (surveying cases and commentary).

240 *See* Nixon v. Blackwell, 626 A.2d 1366, 1375–79 (Del. 1993).

241 *See, e.g.*, Auriga Capital Corp. v. Gatz Props., LLC, 40 A.3d 839, 851 (Del. Ch. 2012) (describing how, in the corporate context, general fiduciary duties may not be waived).

limited partnerships and LLCs can alter or entirely eliminate fiduciary duty or replace it with such contractual provisions as they saw fit.[242]

This left open the critical issue from our perspective: What was the interpretive default rule—a contextualist fiduciary duty standard or a textualist's examination of the entity's organizational documents? The issue was especially important in Delaware because it was apparent that Delaware had a mixture of sophisticated and unsophisticated users of LLCs, but with the majority in the sophisticated category. As of the end of 2010, 550,238 LLCs had been organized in Delaware, including 82,207 in 2010 alone. The population in Delaware at the close of 2010 was 897,934.[243] Most of the Delaware LLCs therefore were organized on behalf of people outside of Delaware, the choice of an organization state other than the organizers' home state itself being a fair signal of sophistication.

Consistent with our discussion of how a contextually informed court can and should protect the interests of legally unsophisticated commercial parties, the Delaware Chancery Court concluded in *Auriga Capital Corporation v. Gatz Properties, LLC*, that fiduciary duty applied as a default in LLCs unless the entity's organizational documents modified or eliminated it.[244] This led to a moderately unseemly exchange between the Chancellor of Delaware and the Chief Justice of the Delaware Supreme Court. The Chief Justice, in a law review article written before the *Auriga* decision, had strongly advocated for a default rule that eliminated fiduciary duty—if legally unsophisticated parties wanted fiduciary duties, they should have to say so.[245] The Chancellor was not convinced. In a lengthy opinion the Chancellor adopted the contextualist default rule, leaving it to legally sophisticated parties to opt out through their drafting of the organizational documents.[246]

On appeal, the Delaware Supreme Court in a per curiam opinion concluded that the Chancellor's discussion in *Auriga* was dicta (an arguable position) and chastised him for addressing the issue at all: "[I]t was improvident and unnecessary for the trial court to reach out and decide, *sua sponte*, the default duty fiduciary issue as a matter of statu-

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242 The story, involving repeated interaction between the chancery and the supreme court that was finally resolved by the Delaware legislature, is recounted in CHOPER, COFFEE & GILSON, *supra* note 239, at 816–22. The alternative entities cannot, however, waive the contractual duty of good faith and fair dealing.

243 Mohsen Manesh, *What is the Practical Importance of Default Rules Under Delaware LLC and LP Law?*, 2 HARVARD BUS. L. REV. ONLINE 121, 128 n.32 (2012), *available at* http://ssrn.com/abstract=1991190.

244 *See* 40 A.3d at 849–56.

245 *See* Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221, 233–42 (2009).

246 *See Auriga*, 40 A.3d at 849–56.

tory construction."[247] The supreme court then went on, itself in (quite pointed) dicta, to set out the Chief Justice's side of the argument.[248] The matter finally was resolved in favor of the Chancellor by the Delaware legislature—the default rule was fiduciary duty.[249] Put in our terms: text *and* context. Legally unsophisticated parties could not take advantage of the Delaware LLC statute's invitation to elect a textualist regime—uncertainty and scale made the drafting task infeasible. The result was an outcome in this contracting context consistent with what we present here: parties are empowered to design their LLC contract, but smaller-entity owners—the corner grocery store as opposed to the venture capital fund—are protected by a contextualist default rule that specifies a standard whose satisfaction is determined by an expert court—the Delaware Court of Chancery.

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247 Gatz Props., LLC, v. Auriga Capital Corp., 59 A.3d 1206, 1218 (Del. 2012) (per curiam).

248 *See id.* at 1218–22.

249 DEL. CODE ANN. tit. 6 § 18-1104 (West 2013) ("In any case not provided for in this chapter, the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law merchant, shall govern.").

Independent of the merits of the particular controversy, the dispute between the chancery court and the supreme court recalls the tension between law and equity recounted in Part II above. The chancery court chooses to protect its recourse to context—the application of its specialized expertise to make a standard viable in the face of significant uncertainty. The supreme court sounds more like a law court. This is not the first time that the chancery court and the supreme court have faced off in a fashion that recalls the tension between equity and law, albeit internal to the Delaware judicial system (the Delaware Chancery Court is explicitly a court of equity; the Delaware Supreme Court, of course, is not).

A similar tension has existed between the chancery court and the supreme court for twenty-three years and over the terms of three successive chancellors over whether the ability of a target board of directors to decline to remove a poison pill blocking shareholders from deciding whether to accept a hostile takeover would be resolved through detailed examination of the context of the transaction as advocated by the three chancellors, or by a rule-like approach that gives great deference to the target, as adopted by the supreme court. *See* CHOPER, COFFEE & GILSON, *supra* note 239, at 980. The character of the equity versus law tension appears from Chancellor Chandler's comment in a case decided just prior to his retirement:

> Although I have a hard time believing that inadequate price alone (according to the target's board) in the context of a non-discriminatory, all-cash, all-shares, fully financed offer poses any 'threat'—particularly given the wealth of information available to Airgas's stockholders at this point in time—under existing Delaware law, it apparently does. . . . In my personal view, Airgas's poison pill has served its legitimate purpose.

Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 56–57 (Del. Ch. 2011). Justice Jack Jacobs, who has seen this tension from both the perspective of sitting on the chancery court and on the supreme court, compares the tension to that between law and equity in seventeenth-century England—like we do. Jack B. Jacobs, *The Uneasy Truce Between Law and Equity in Modern Business Enterprise Jurisprudence*, 8 DEL. L. REV. 1, 9, 13 (2005).

Conclusion

The battle over the generalizability of competing contract prototypes has been fueled by competing ideas of the nature of the decision process that gives rise to a contract and how that should guide its interpretation. For textualists, the allocation to the parties to decide who chooses the mix of text and context and when that choice is best made is the expression of intent of an autonomous agent, who can, with the help of legal counsel, articulate its aims and anticipate its most advantageous reactions to contingencies. For contextualists, the interpretive choice always contains an irreducibly social component: individual intentions, and the associated expectations of others, are always enmeshed in a web of common understandings and a shared, practical sense of mutual obligation. It is as impossible as it is unnecessary to articulate them fully: impossible because the understandings and obligations are tacit and resist explication; unnecessary because they are widely shared, and so are typically available as guides to action even when they cannot be fully articulated.

By examining the array of interpretive regimes that occupy the contracting design space we see the limitations of both conceptions. The textualist understanding of the exercise of ex ante choice as freestanding, articulate, and prescient cannot make sense of the increasing intrusion of uncertainty into the familiar world of probabilistic contingencies, and with it the spread of forms of collaborative contracting: here sophisticated parties encounter the limits of prescience, seeking in collaboration the possibility of gradually articulating intentions, most directly by joint learning from a context jointly created. Conversely, the manifest inability of generalist courts in a dynamic society to construe evanescent commercial practices, and the growing realization that even in steady times customary rules do not emerge spontaneously from practice, exposes the limits of the contextualist understanding of shared norms discovered by ex post adjudication. Where textualists are driven to explore forms of sociability broadly associated with contextualism, contextualists are driven to enquire into the design of institutions capable of articulating, at least partly, tacit understandings, making them more accessible to the kind of deliberate control broadly associated with textualism. Both must acknowledge dependence, in many settings, on a wide range of interpretive regimes—public and private—that function as complements to common law adjudication rather than as antagonists.

There is no reason to think that the differences in textualist and contextualist positions will disappear fully over time, or that a convergence in the concepts of ex ante choice and ex post adjudication will lead ultimately to a novel synthesis. Nor should this be a cause for regret. We have no more need for a unified idea of "who decides"

than for a unified concept of contract to respond effectively to the diverse settings in which we transact. But perhaps it is not too much to expect that careful attention to the wide variety of contracting practices will further weaken the grip of textualism and contextualism as the master ideas of doctrine and legal imagination. And that attention may also help clear the way for more practically supportive appreciation for innovations in contract design, surprising judicial successes such as the revival of "traditional" courts of equity, and the role of interpretive regimes, established and emergent, in the resolution of contract disputes.