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## Rules for Interpreting Incomplete Contracts: A Cautionary Note

Steven L. Harris\*

I am very honored to have been invited to participate in this symposium in honor of Bill Hawkland. Many thanks to Jim Bowers for coming up with the idea and to Jim, as well as the Louisiana Law Review, for bringing it to successful fruition.

I am especially pleased to participate because of my longtime connection with Bill Hawkland. The University of Illinois College of Law, on whose faculty I served for a dozen years, is among a very small number of major law schools that do not merely value, but prize, contributions to law reform—and particularly to the reform of commercial law—as well as “practical” and “doctrinal” scholarship. I have no doubt that this welcoming attitude was a direct consequence of Bill Hawkland’s having served two tours of duty at Illinois.

Some years ago, I had the great pleasure of working closely with Bill on the revision of U.C.C. Article 6 on bulk sales, first as the advisor from the American Bar Association and then as Bill’s co-reporter. I suspect the Article 6 project was unique in the history of private legislatures. Given this group’s interests, perhaps the history of Article 6 deserves a few words here.<sup>1</sup> The Drafting Committee was charged with the task of revising Article 6. But rather than accept its jurisdiction, or even expand it, as so many committees are wont to do, the committee (very soon after its appointment) actually tried to put itself out of business by recommending repeal. In response, the Executive Director of the National Conference of Commissioners on Uniform State Laws (“NCCUSL”) informed us that our charge from the Scope and Program Committee was to *revise* Article 6, and that we lacked jurisdiction to recommend repeal. So we got to work and revised the Article. Three years later, when the Article was up for approval at the NCCUSL Annual Meeting, it became clear from the floor discussion that some Committee members had reservations about the entire concept of a bulk sales law. Ultimately, the members were asked to indicate their preferences, as between the revision they had worked several years to fashion and repeal. With one exception, the members favored repeal,

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1. For a fuller discussion of the process by which U.C.C. Article 6 was revised see Steven L. Harris, *Article 6: The Process and the Product—An Introduction*, 41 Ala. L. Rev. 549 (1990).

and NCCUSL adopted this position as its primary recommendation.<sup>2</sup> Bill's and the Committee's work did not go completely for naught. For those states that chose not to revise, NCCUSL recommended adoption of the revised version. To date, only five states have adopted the revision, while over 40 have repealed. My strong hunch is that Bill has not been disappointed with the outcome.

Having cut my teeth on Article 6, I was asked to serve on the Study Committee for U.C.C. Article 2 and then to join Chuck Mooney as a reporter for the Drafting Committee to Revised U.C.C. Article 9. After more than a decade of active involvement in reform of commercial law, I cannot help but view the Bowers and Scott debate<sup>3</sup> on the appropriate role that context should play in the interpretation of contracts through the eyes of a statutory draftsman. It is from this perspective that I offer these comments.

Although abstract debates are both interesting and helpful, any substantial change in judicial conduct is likely to require a legislative solution. The inherent limits to such a solution are substantial. First, these issues are complex. Under what circumstances may a court look to evidence of context? Which facts are relevant? What is the relationship between the context and the written agreement of the parties? In addition, the statutory rules need to be comprehensible to, and readily susceptible to proper application by judges with incomplete and imperfect information. Given the vast array of different facts and circumstances upon which the U.C.C. operates and the broad range of judicial talent, one must expect that the legal regime will not generate the "right" answer in every case. The question is whether the U.C.C.'s provisions for interpreting contracts in context can be materially improved upon.

No one can deny the appeal of interpreting the language of a contract in context. Like other documents, contracts are drafted against a host of background assumptions and understandings, some of which are quite basic. Strategic considerations aside, the cost of bringing all these assumptions from the background to the conscious mind and reducing them to writing often is prohibitive. The errors that can arise from failing to interpret contracts in light of these unexpressed assumptions and understandings are so readily apparent

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2. Not coincidentally, the lone dissenter represented the Commercial Law League of America, a trade organization that, among other things, promotes the interests of unsecured creditors.

3. Compare, e.g., 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* 149 (Jody S. Kraus & Steven D. Walt eds., Cambridge Univ. Press 2000), with James W. Bowers, *Incomplete Law: On the Inevitable Inadequacies of Codes, Civil and Commercial*, 62 La. L. Rev 1229 (2002). [hereinafter "Bowers"].

and potentially egregious that, if the goal of contract law is to give effect to the parties' actual agreement (or, in the words of the U.C.C., "the bargain of the parties in fact"), resort to matters outside the express language of the parties would appear to be essential.

Jim Bowers' discussion of how courts would construe a contract to build a building with perfectly straight walls provides a perfect example,<sup>4</sup> as does the familiar example in the U.C.C. context of a contract for the sale of two-by-four's. Anyone with any familiarity with the subject matter of these contracts knows that the parties actually contemplate neither perfectly straight walls nor boards that are two inches by four inches. Interpreting these contracts solely by using Webster's dictionary gets us to what I think all will agree are the wrong answers. Assuming we want to enforce the actual agreement of the parties, reference to something other than the standard dictionary is essential. At a minimum, we must look to usage of trade.

One might argue that parties who intend for their words to be understood in context should express that intention in their written agreement. The U.C.C. rejects that approach and makes clear that even if a particular contracting party is not aware of a usage of his trade applicable to the transaction in question, his contract nevertheless will be interpreted in the light of that usage.<sup>5</sup> This notion, that if you are going to play the game, you are deemed to know the rules (a variation on the theme of *ignorantia legis neminem excusat*) prevents the kind of costly and potentially indeterminate inquiry that would arise if one inquired into the subjective intentions of the parties. It says to merchants: If you don't want to be bound by trade usage, you must incur the costs of learning the usage of your trade and expressly contracting out of it.

This burden is similar, but not identical, to the one that formalists would impose by limiting interpretation to the "plain meaning" of the contract. Parties who wished to use language in a manner that would counteract the meaning otherwise attributed to it by the interpretive device (i.e., the dictionary or the relevant usage of trade) would need first to appreciate the need to do so. That is, they would need to be informed of the rule of interpretation (which is no small assumption) and to realize that the meaning they ascribe (in their heads) to crucial terms differs from that of the interpretive device. Having realized the need to take into account the interpretive device, they must then either translate their bargain effectively from their own language to that of

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4. See Bowers, *supra* note 3, at 1269-1274.

5. "A course of dealing between parties and any usage of trade . . . of which they are or should be aware give particular meaning to and supplement or qualify terms of an agreement." U.C.C. § 1-205(3) (2001).

the dictionary or indicate unambiguously that the particular usage of trade should not be applied. My hunch is that, in the aggregate, the burden of the dictionary rule is greater. Usage of trade, by definition, has substantial regularity of observance,<sup>6</sup> so much so that it is relatively unlikely that parties will seek to contract out of it and more difficult for parties to recognize that their words express a specialized, rather than a dictionary, meaning.

Assuming then, that one's goal is not to force parties to express the interpretive context in their written agreements, the objection to the U.C.C.'s scheme of interpreting words in context cannot be to the use of any and all information other than the express words of the contract to understand what the parties are talking about. Some of that information must be available to guide in interpretation if we wish to give effect to the parties' bargain. On the other hand, as Jim Bowers points out, legal rules determine outcomes based on particular facts.<sup>7</sup> The problem is that we cannot have a separate rule legal rule for each possible set of facts. As is so often the case in law, we need to find the right level of generality—the right mix of rules and standards—so that the courts have sufficient guidance to lead them to the right results, to enable the parties to plan their dealings with sufficient certainty, and to yield outcomes that appear to be sufficiently grounded in law so as to promote respect for the courts and the rule of law.

In determining the bargain of the parties in fact, the U.C.C. limits the relevant facts to objective manifestations that are thought to reflect that bargain or give meaning to the parties' expression of it—usage of trade, course of dealing, course of performance, and the like. One complaint, as I understand it, is that these interpretive guides, at least as applied by the courts, don't yield the right answers.<sup>8</sup> Of course, to conclude that the courts got it wrong, we ourselves must know what the parties really intended. Determining intent is exceedingly difficult, given that a party may hold mixed and conflicting attitudes and ideas at any given time, that these may be quite nuanced and fact-specific, and, as research into cognition has shown, that one's understanding of one's own intent may even depend on how the question is phrased. In many cases, a party may have formed no specific intention with respect to the meaning of particular terms of the contract in a given setting. So the very exercise itself may be indeterminate.

Let's assume that courts are making mistakes more often than we think necessary. One cause may be the way in which courts apply the

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6. See U.C.C. § 1-205(2) (2001).

7. Bowers, *supra* note 3, at 1240.

8. Scott, *supra* note 3.

rules. Certainly there are lines to be drawn. Consider, for example, the U.C.C.'s rules concerning usage of trade.<sup>9</sup> Does the usage in question "give particular meaning to" or "supplement" or "qualify" express terms of an agreement? In other words, when I refer to a two by four, do I "mean" a board one and one-half inches by three and one-half inches (which are the standard dimensions of a two by four)? If so, then the trade usage (assuming it has sufficient "regularity of observance") *should* be utilized for that purpose. Or is the trade usage such that it would be unreasonable to construe the express terms of the contract (two by four) as being consistent with the trade usage — that is with a board one and one-half inches by three and one-half inches? The context in which the issue arises may have some influence on the outcome. For example, it might be easier for a lumber merchant who provided boards that are one and one-half inches by three and one-half inches to persuade the court that two by four means one and one-half inches by three and one-half inches than it would be for a buyer who rejected boards that actually were two by four to persuade the court that a two-inch by four-inch board is *not* a two by four. In any event, courts are asked to draw lines all the time. The line-drawing exercise seems no more difficult here than it is elsewhere; the need to draw this line (and similar lines) with respect to context does not explain why courts misinterpret sales contracts more often than other contracts (if in fact they do).

Another possible source of error is that judges have misapplied the U.C.C.'s rules of interpretation, by failing to give proper weight to certain evidence such as the express terms of the contract or by interpreting the contract by reference to matters that should not be taken into account under the U.C.C.'s scheme.<sup>10</sup> Perhaps we should reconsider the articulation of these rules in the U.C.C.. Are the rules difficult to understand? Do they make clear that the search for subjective intention must be conducted only by reference to objective manifestations, such as usage of trade, course of dealing, and course of performance? Or, is the invitation to determine the parties' agreement "by implication from other circumstances" too open-ended? Are the limitations on the use of usage of trade, course of dealing, and course of performance not strong enough to overcome possible preconceptions and cognitive biases? For example, are the admonitions in Sections 1-205 and 2-208, that "express terms control" course of dealing and course of performance, sufficient to overcome any bias that "actions speak louder than words"?<sup>11</sup>

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9. U.C.C. § 1-205(2), (3), (4) (2001).

10. Elsewhere in this symposium, Bob Hillman has suggested that this is not the case, at least as regards course of performance. See Robert A. Hillman, *More in Defense of U.C.C. Methodology*, 62 La. L. Rev. 1153 (2002).

11. The standards for determining whether there is a relevant usage of trade,

It may be that judges simply are not competent to apply these concepts properly, but the concepts do not seem to be any more difficult than others that we require our judges to apply. Perhaps the proper application of usage of trade and the like requires more knowledge of business practices, or of the practices of a particular business, than judges bring to the job or acquire during the case. Lawyers have the responsibility to discover, present, and assist courts in analyzing the context in which contracts are entered into and performed. As Jim Bowers correctly points out, construing contracts by reference to context is “expensive lawyering.”<sup>12</sup> No doubt some cases do not justify the expense. But in those that do, the lawyers need to understand that, to do the job right, they must incur the expense. The lawyer must know to look for the context. Part of the problem may be that the lawyers whose job it is to inform the court do not understand the transactions themselves. This may be a function of the fact that most litigators do not specialize in the transactions of a particular industry. Although the client often is a useful source of information concerning relevant commercial practices (for example, the client is likely to be informed of relevant usage of trade), in other circumstances the client may not be able to help. In some cases, the lawyer’s failure to educate the court may be a function of bad lawyering. I’m sure I am not the only symposium participant who has been asked for advice about structuring a legal argument in a commercial case *after* discovery has been closed. And I’ve seen many cases of litigators in large firms—lawyers who are least likely to be informed of trade usage and the like—who have pursued litigation to conclusion without even consulting with the lawyers who negotiated the contract at issue.

Another concern about the current state of affairs is that the judicial opinions construing contracts under Article 2 do not enable parties to predict accurately how their contracts will be construed in the event of a dispute (i.e., that predictability is inherently in tension with the U.C.C.’s “incorporation” strategy).<sup>13</sup> In one sense, there may be only a little tension. Everyone can predict that not only the express words but also other objective manifestations will be used to

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course of dealing, or course of performance, and the rules for using these facts in the interpretation of contracts, are much clearer than the guidance given with respect to certain other gap-fillers, such as “commercially reasonable” and “good faith.” Although Section 1-204 sets forth the considerations to be taken into account when determining what constitutes a “reasonable time,” the U.C.C. does not expressly require the court to refer to actual commercial practice when determining what is “commercially reasonable.” Perhaps it should. But the U.C.C. does require recourse to agreed standards of reasonableness if the standards themselves are “not manifestly unreasonable.” U.C.C. § 1-102(3) (2001).

12. Bowers, *supra* note 3, at 1273.

13. See Scott, *supra* note 3.

determine the bargain-in-fact. If the goal of contract law is to give effect to the subjective bargain of the parties, insofar as we can determine that intention through objective manifestations, then differences in the relevant objective manifestations may well reflect differences in result. Whether the result is predictable to another pair of contracting parties depends upon whether the parties can predict the content of the objective manifestations that will be used as interpretive guides to their intentions.

Predicting accurately may not be easy. Take, for example, the opinion in Jim Bowers' imaginary case of *Bank v. Fred*, which concerns a blue promissory note.<sup>14</sup> Jim asks whether the opinion disposes of the next case, in which the promissory note is pink. He writes:

If we passed kindergarten, we know that pink isn't literally blue either. We can say, however, that the world would contain less welfare if we imposed needless and potentially costly color formalities on the promise-making process. That normative standard justifies us in disregarding the color distinctions in the two cases.<sup>15</sup>

"Needless and potentially costly," there's the rub! How does the court, or the lawyers who are arguing the case, know that the color formalities are needless and potentially costly? Jim assumes (I think correctly) that there is no benefit to distinguishing between promissory notes on the basis of color. But suppose the case concerned a warehouse receipt or bill of lading? Here, a practice has developed to distinguish negotiable documents of title from non-negotiable ones on the basis of color. Negotiable documents are printed on colored paper—warehouse receipts are green and negotiable bills of lading are yellow—whereas non-negotiable documents are printed on white paper. So, the idea that the meaning of a contract might be affected by the color of the paper on which it is written may not be as outrageous as it first appears. Conceivably, different judicial opinions might reach opposing results on the principled basis of the color of the paper, yet the outcome of the second case would be unpredictable to the casual observer. And, unless the second opinion explained the considerations carefully, it might even convey the impression that the opinions cannot be reconciled.

Contributing to the unpredictability is the fact that some of the interpretive guides, especially course of performance, acquire their content *after* the written contract has been signed. The "solution" to

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14. See Bowers, *supra* note 3, at 1250.

15. *Id.* at 1252.

this uncertainty is for the parties either to acquiesce in the idea that the court will call it as it sees it and take the leap of faith that the court will get it right, or contract out with sufficient clarity (“and we really mean it”). The question, of course, is whether the parties really do mean it—and if they act as if they do not, whether the world is a better place if we hold them to their words or if we give legal effect to their adaptations over time.

We are left with finding the right recipe for reading words in context. If we give too much room for context to determine outcomes in a search for perfect justice (or for a perfect understanding of the bargain of the parties), we may risk errors in interpretation and may increase uncertainty. However, if we limit the evidence that can be used, we create problems of over-inclusion and under-inclusion to which Jim Bowers’ paper refers. Perhaps in an ideal world we would be able to determine the relative error, uncertainty, and transaction costs generated by each possible level of generality. But even if we knew those, framing a statute that successfully uses the data as the basis for the applicable legal rules and successfully prompts the judiciary to decide cases in a manner that actually minimizes the costs would be a daunting task. As written, the U.C.C. leaves ample room for effectuating the parties’ bargain in fact by determining whether there is relevant evidence of context and applying the evidence judiciously. The insights generated by the academic debate are, at least at this stage of their development, unlikely to yield a workable improvement.