THE LAW OF CONTRACTS

SUPPLEMENTAL READINGS

Class 07

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EXAMPLES & EXPLANATIONS

Contracts

Seventh Edition

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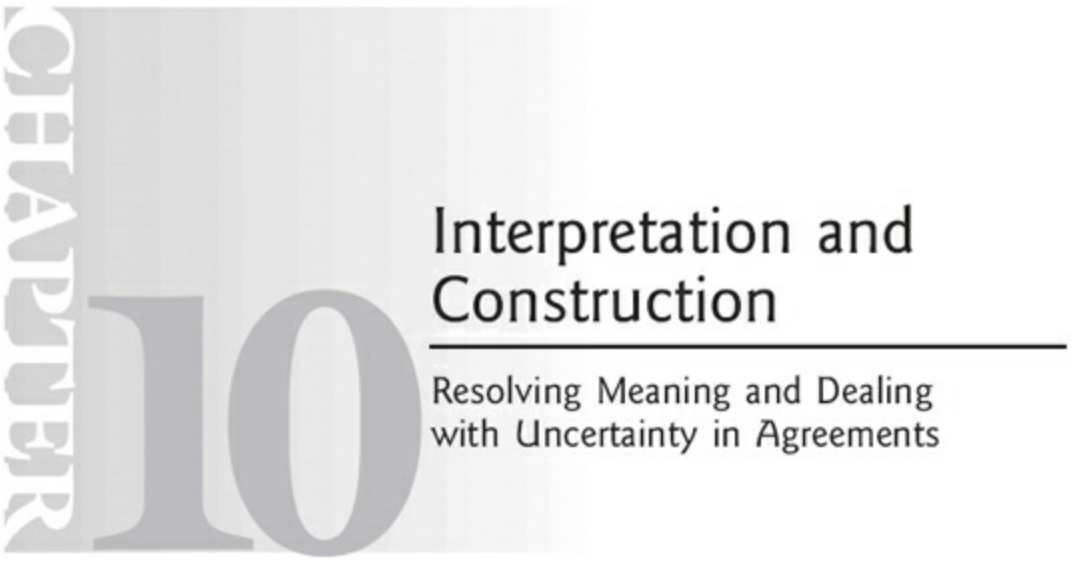
Wolters Kluwer



§10.1 ASCERTAINING THE MEANING OF AN AGREEMENT: INTERPRETATION AND CONSTRUCTION

§10.1.1 Introduction to the Process of Interpretation and Construction

The processes of interpretation (inferring meaning from facts) and construction (inferring meaning as a matter of law) have been alluded to in earlier chapters.[1] If you have read them already, the basic point of the present discussion will not be entirely unfamiliar. This section more closely examines and differentiates the methods and uses of the related, but separate, functions of interpretation and construction. To begin, a broad distinction may be drawn:

Restatement, Second, §200 describes interpretation as the ascertainment of the meaning of a promise or agreement. It is an evaluation of facts (that is, evidence of what the parties said and did and the circumstances surrounding their communications) for the purpose of deciding their mutual intent. The

word “construction” is sometimes used interchangeably with “interpretation,” but properly speaking, it does have a different meaning. Construction is the implication of a term in law. It usually occurs where it appears that the parties did not actually deal with a particular issue in their contract, and there is no factual evidence to establish how they intended that issue to be handled. That is, although it is clear that the parties did make a contract, they just did not address this particular issue. The court may therefore determine, based on what it knows of the contract and its context, how the parties would have dealt with this issue had they thought of it. Stated differently, a court will use the process of construction only when the existing evidence supports the reasonable conclusion (based on objective manifestations of assent) that the parties did intend to make a contract, but there is little or no evidence from which a factual inference can be drawn on their intent regarding a particular aspect of that contract. In seeking to effectuate the parties’ intent, the court builds on what it knows of the transaction to interpolate from that a meaning that the parties probably would have agreed on, had they focused on the issue. Although courts are wary of devising an agreement that the parties did not actually make, it is sometimes preferable to do this instead of defeating contractual expectations by demanding clear proof of intent for every gap and uncertainty.

The difference between interpretation and construction can be subtle. *Wood v. Lucy, Lady Duff-Gordon*, 222 N.Y. 88 (1917), discussed in section 7.9.2 in relation to illusory promises, may be used as an illustration. Lucy, a well-known fashion designer, appointed Wood as her exclusive agent to sell her designs and place her endorsements on the designs of others. Under their agreement, Wood was to pay Lucy half the profits generated by the sales and endorsements. However, Wood did not actually promise in the agreement that he would do anything to promote her designs and endorsements. Lucy endorsed products on her own and kept all the proceeds. When Wood sued her for his share of this income, she argued that they had no valid contract because Wood had given her no consideration. Even though he promised to share any profits that he generated, he made no promise to do anything to earn those profits. In a famous opinion by Judge Cardozo, the court rejected that argument on the basis that Lucy’s grant of an exclusive agency to Wood, under circumstances in which the parties clearly intended a serious commercial relationship, gave rise to the implication that Wood had obligated himself to use best efforts to earn profits. If the court’s recognition of Wood’s

promise to use best efforts was based on evidence of intent, such as discussions in negotiations, a course of performance by the parties after the agreement had been made, or prevailing usage in the trade, the court would have reached its conclusion as a matter of interpretation. However, if there was no such evidence, the court's implication of the obligation to use best efforts is construction—the court finds that term based on what the parties would rationally have agreed had the question been presented to them at the time that they made the agreement.

As this shows, there is often a fine dividing line between interpretation and construction. In addition, in most cases the distinction is not of great practical significance because the end result—the establishment of meaning—is the same. However, the distinction is important to an understanding of the process by which courts resolve disputes over the meaning and scope of contract terms.

§10.1.2 Interpretation as a Question of Fact or Law

There is some confusion over the proper roles of the judge and jury in deciding the meaning of agreements, and cases offer conflicting views on whether the ascertainment of meaning is a matter of fact or law. Where interpretation involves the determination of meaning by the evaluation of evidence, it is most appropriately performed by the finder of fact—the jury, unless the case is being tried without one. However, if interpretation merely involves the ascertainment of the plain or ordinary meaning of words, and there is no factual dispute requiring an assessment of credibility, or where meaning must be construed based on what the parties must have intended, the determination of meaning is a legal question for the judge. This dichotomy is not always carefully observed by courts, and the fact-law distinction sometimes becomes blurred. This is particularly so where meaning is based on a combination of the grammatical meaning of words, contextual evidence, and legal implication. In such cases, it can be very difficult to unravel the proper roles of judge and jury, and concern about control over decisionmaking tends to push in the direction of the judge assuming the function of weighing the relative probity of these different elements.

Apart from the question of who decides meaning, the fact-law distinction has significance beyond the trial phase of the case. If meaning is determined as a matter of law, it can be reversed on appeal on the standard of

review for legal questions: that the judge erred in the application of the law. However, if the determination is a question of fact, it can be reversed only if it satisfies a much stricter standard: The evidence must provide no reasonable basis for supporting the factfinder's conclusions. Also, a legal determination has weight as precedent, but a factual one does not.

§10.1.3 The Sources of Evidence Used in Interpretation

The process of interpretation was introduced in section 4.1 on the objective test, where it was noted that agreement is manifested by the use of outward signals: words—whether written or spoken; actions; and, in appropriate situations, a failure to speak or act. As the parties move toward developing consensus in the process of contract formation, intent thus communicated by each party is necessarily interpreted by the other. If a dispute later arises about whether consensus was reached or about what was agreed, the communications of the parties must again be interpreted—this time in court—to determine which party's interpretation is correct. Under the objective test, meaning is based on how words and actions reasonably would be perceived by the party to whom they were manifested. The subjective understanding of the parties may have some relevance to the inquiry to the extent that it is consistent with, and may help explain, the meaning of the manifestation.

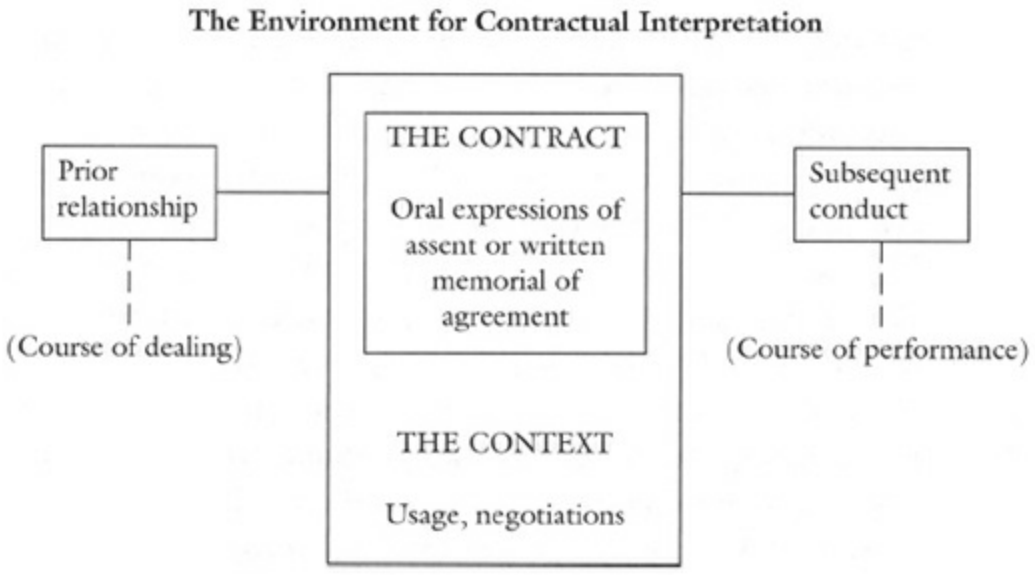
This section looks more closely at the process of interpretation and examines the type of evidence that may be available to cast light on the meaning of manifestations of apparent intent. Interpretation first focuses on the normal, accepted meaning of the words used by the parties. However, words are never spoken in a vacuum, so there is always some context in which the words were used. To the extent that this context provides information of what the words might mean, the process of interpretation goes beyond the language used by the parties to take this context into account.

Of course, context does not always provide information that may be relevant to the meaning of a term in dispute, so neither party may be able to offer contextual evidence that bears on what the parties must have meant. Where the court has no evidence of meaning extrinsic to the bare language of the agreement, it is necessarily confined to interpreting that language to ascertain its meaning. However, where a party does seek to prove contextual evidence pertinent to meaning, that evidence should be considered and given

appropriate weight. The degree to which it is persuasive often depends on the clarity of the contractual language. Where the contract expresses the disputed term in apparently clear and unambiguous language, extrinsic evidence as to its meaning is treated with caution.[2] Some courts are quite strongly resistant to considering extrinsic evidence if the language used in the contract is clear on its face. (This strict "four corners" approach is more common in older cases.) Other courts are more receptive to extrinsic evidence because they recognize that words do not have a constant and immutable meaning and can be colored by context. Because interpretation aims at ascertaining the intended meaning of words, those courts consider it important to hear available contextual evidence in trying to decide what meaning the parties intended.

Where contextual evidence is available and pertinent, the interpretation of a contract involves five principal areas of factual inquiry. At the center of the inquiry are the actual words used by the parties in the agreement. Even where there is contextual evidence, the language of the agreement is the starting point and the primary source of meaning. The wording of the very term in dispute is the central focus of the interpretation effort, but it cannot be read in isolation from the rest of the agreement and must be interpreted in light of the document (or oral agreement) as a whole. Beyond the language of the agreement, the inquiry spreads to its context. This context includes the discussions and conduct of the parties when they negotiated the contract, their conduct in performing the contract after it was formed (course of performance), their conduct in prior comparable transactions with each other (course of dealing), and the customs and usages of the market in which they are dealing with each other (trade usage). (*See* Diagram 10A.)

Diagram 10A



Notice that in each of these five areas we are concerned with objective evidence, in the form of words or conduct manifested by the parties, or verifiable facts in the contractual environment. The evidence of one party concerning what she may have thought or believed is only marginally helpful or relevant. Obviously, not all of these components are present in every transaction. However, the more that exist in a transaction, the richer the background from which meaning can be ascertained. In a fortunate case, all the evidence drawn from these different aspects of the context will point to the same meaning. If they conflict, the general rule (reflected in UCC §§1.303(e) and 2.208(2) and in Restatement, Second, §203(b)) is to give greatest weight to the express terms of the parties, followed in order by any course of performance, course of dealing, and usage.

We will look more closely at these indicators of intent in the rest of this section. Before doing so, it is enlightening to see how they were used by the court in one of the best illustrative cases on this subject, *Frigaliment Importing Co. v. B.N.S. International Sales Corp.*, 190 F. Supp. 116 (S.D.N.Y. 1960). The buyer, a Swiss importer, ordered a large quantity of chicken from the seller. The contract called for "U.S. fresh frozen chicken, grade A" of two different sizes. The agreement reflected a lower price per pound for the larger chickens than the smaller ones. When the seller delivered the chickens, the buyer protested that the larger, cheaper ones were not in accordance with the contract because they were stewing chickens, not suitable for frying. The buyer claimed that the word "chicken" used in the

contract meant frying chicken so that all chicken delivered had to be of this quality. The seller denied that it had breached the contract by delivering stewing chickens. It contended that the word "chicken" was a generic term for both frying and stewing chickens and that the price difference in the contract made it clear that the cheaper birds would be stewing chickens.

The subsequent litigation centered on the meaning of the word "chicken" as used in the contract. The definition of "chicken" in dictionaries and U.S.D.A regulations did not exclude either party's meaning. The court's examination of the terms of the contract document as a whole was somewhat more helpful in casting light on the meaning of "chicken." The price term supported the seller's contention that two different types of chicken were contemplated because the price of the larger birds was below the market price for fryers. The court moved beyond the written agreement to explore the entire context of the transaction in an attempt to decide if "chicken" should be understood in the narrower or wider sense. Several experts testified as to the meaning of "chicken" in the trade, but the expert testimony was in conflict and did not clearly support the position of either party. Finally, the court considered evidence of the parties' course of performance to see if it cast any light on what they may have meant. The course of performance did not show a common intention because the buyer protested about the stewing chickens immediately on delivery. In the end, despite these efforts, the court was not able to establish what the parties meant by the use of the word "chicken" in the contract, so the case was resolved on the basis of the burden of proof. The buyer lost because it failed to prove that the word was used in the narrow sense that it alleged.

We now move to a more detailed consideration of each of the indicators of intent sketched above.

a. The Express Words Used by the Parties

The ordinary meaning of words used by the parties in formulating their rights and obligations is always the primary indicator of what they intended. Restatement, Second, §203(b) and UCC §§1.303(e) and 2.208 give greatest weight to express terms. These express terms might be oral, written, or otherwise recorded.[3] As noted above, although the language of the disputed term is at the center of the court's examination of the express terms, the court does not look at that language in isolation, but reads it in light of the

agreement as a whole—it reads all the terms of the written agreement or considers the entire oral contract. Often terms in one part of a contract cast light on terms in another. This is illustrated by the relevance of the price term in the *Frigaliment* contract to the question of whether the word "chicken" included stewing chickens.

Of course, interpretation of the ordinary meaning of the parties' language is not always a simple and mechanical matter, and different judges could find different meanings in the same words. For example, in *Breeding v. Kye's, Inc.*, 831 N.E.2d 188 (Ind. App. 2005), Breeding reserved Kye's hall for her wedding. The written agreement stated that $600 of the fee for the facility was for the services of a disc jockey. The agreement also made it clear that the client had no choice of disc jockey because Kye had granted an exclusive license to Sounds Unlimited Productions to provide disc jockey services for all events at the hall. (This suited Breeding well because the owners of Sounds Unlimited were friends of her family and she wanted Sounds Unlimited as the disc jockey at her wedding. In fact, this was apparently why she selected Kye's venue.) About three months before the wedding, Kye notified Breeding that its license arrangement with Sounds Unlimited had terminated, and it would not permit Sounds Unlimited to work in its hall. Kye would not budge in its refusal to allow Sounds Unlimited onto its premises, even though Breeding was willing to hire Sounds Unlimited herself. Breeding sued Kye for breach of contract and return of her deposit on the basis that Kye had broken its undertaking to provide disc jockey services by Sounds Unlimited. Kye defended the suit on the basis that the contract was merely for the hire of the hall and contained no promise to use Sounds Unlimited. The majority of the court of appeals found that the provisions in the contract relating to disc jockey services clearly and unambiguously constituted a commitment by Kye to provide the services of Sounds Unlimited. Despite the majority's confidence in this clarity, the dissent read the contract terms differently and reached the opposite conclusion. It disagreed that the provisions relating to the disc jockey were a promise to Breeding that Sounds Unlimited would provide the services. Rather, they merely limited the client's choice of disc jockey. (The dissent noted that under the objective test, the express terms of the contract were not affected by Breeding's subjective motivation in selecting the hall because of the disc jockey.)

b. Discussions and Conduct of the Parties During Negotiations

Apart from the actual words spoken or written to express agreement, there may be a history of communication and negotiation leading up to the execution of the contract. Evidence of what was expressed by the parties during the period leading up to contract formation could be useful and relevant to establish the meaning of what was ultimately provided for in the agreement.[4]

c. Course of Performance: Conduct by the Parties in the Course of Performing Under the Agreement

If the parties have begun to perform the contract before the uncertainty to be resolved by interpretation becomes an issue, their conduct in proffering and accepting, or otherwise reacting, to performance may provide evidence of what was intended by an indefinite term. This post-formation behavior is called the "course of performance" and its relevance to interpretation is based on the assumption that the actual performance tendered and accepted without objection is a strong indicator of what must have been intended. The evidentiary value of the course of performance is recognized by UCC §§1.303(e) and 2.208, mimicked by Restatement, Second, §202(4).

For example, a lease provides that "dogs, cats, and other animals may not be kept on the premises." Lessee owns a pet duck that he thinks of as a bird, not an animal. Dictionaries offer alternative definitions of "animal." One includes all breathing creatures, and the other confines it to four-legged land creatures, excluding birds and fish. Lessee has kept the duck on the premises for several months. Lessor has seen it on several occasions and has never complained. The mutual conduct of the parties creates the fair inference that they were in agreement that the term "animals" does not include ducks.

Not all post-formation conduct necessarily reflects what the parties intended at the time of contracting. The conduct may simply not be pertinent to the meaning of the term in issue, or even if it is, it may reflect a subsequent change of mind or a disinclination to enforce rights under the contract. It can be difficult to distinguish a course of performance, which casts light on what the parties meant at the time of contracting, from post-formation conduct that is either a waiver of rights or a modification of the contract. For example, the lessor's failure to complain about the duck could indicate that the parties did

not include it in the definition. However, it could mean instead that the lessor has simply chosen not to enforce the ban on ducks, or that the parties have implicitly agreed by conduct to eliminate the restriction on animals. If it is not a course of performance but a waiver or modification, it is subject to different rules. Therefore, it is possible to draw the wrong inference from behavior that is ambiguous or does not really have a bearing on the term in issue. There are several guidelines that help avoid misconstruing conduct as a course of performance:

1. For a course of performance to be valid as a source of interpretation, it must be pertinent to the meaning of the term in controversy. For example, if the term in dispute concerned the date on which the rent payments were due, lessor's tolerance of the duck does nothing to clarify the uncertainty.
2. The conduct must show that the party performed or accepted performance without a protest or reservation of rights. Therefore, if on each occasion that Lessor saw the duck, she protested that it was not allowed, Lessor's failure to take stronger action does not support the conclusion that the parties intended "animals" not to include ducks.
3. Conduct by only one of the parties, not known and acquiesced in by the other (for example, if Lessee kept the duck inside and Lessor never saw it or knew about it), may show what the performing party understood the agreement to be, but does not prove that the other party shared this view.
4. The more extensive or repetitious the conduct, the stronger the inference that it does reflect what was intended by the parties. By contrast, isolated or single instances of conduct are more ambiguous and could simply be a waiver of, or disinclination to enforce, rights on a particular occasion. For example, merely because Lessor sees the duck on one occasion and does nothing about it, does not necessarily show that she shares Lessee's view of the meaning of "animals."

d. Course of Dealing: Prior Dealings Between the Parties in Similar or Analogous Contractual Relationships

While "course of performance" means the parties' post-contractual

relationship, the term "course of dealing" refers to any relationship they may have had in the period before the transaction in question. The parties may have dealt with each other on prior occasions, and the current transaction may be the latest in a series of similar ones that have taken place over a period of time. If so, the parties' conduct in prior dealings may provide information that helps to interpret a term that has generated a dispute in the present transaction. This is recognized by UCC §1.303(b) and Restatement, Second, §§202 and 203.

For example, Lessee previously rented premises from Lessor under a lease that had the identical clause forbidding animals. During the prior lease term, Lessor discovered the duck and told Lessee to get rid of it or face eviction. He sadly obeyed and boarded it with his mother. When the parties enter into a new lease with the same term, it is reasonable to infer that they intend its wording to have the meaning established under the prior relationship. If they intend otherwise, they must make this clear in the new lease. If they do not, Lessee cannot claim that the parties intend that "animals," as used in the new lease, does not include ducks.

A course of dealing is only pertinent if the earlier relationship is comparable or analogous. The transactions must be substantially similar, the term in controversy must have been present in the earlier dealings, and past conduct must be relevant to the meaning in issue. As with course of performance, repetition strengthens the inference, so multiple transactions with consistent, pertinent behavior more clearly establish intended meaning.

e. Trade Usage, Common Usage, or Custom That Is Reasonably Applicable to the Parties' Dealings

Although the ordinary or general sense of words must be the starting point in any exercise of interpretation, UCC §1.303(c) and Restatement, Second, §§202(5) and 222 emphasize the significant impact of trade usage on the meaning of language. Parties usually deal with each other in the context of a larger community. This may be a particular market (whether international, national, or more local), or it may be a specialized trade or industry. If the market has a well-accepted custom or practice that explains language or supplements an omission in an agreement, this customary usage is of value in ascertaining the parties' intent. Although UCC §1.303 and Restatement, Second, §§202(5) and 222 use the term "usage of trade," this does not mean

that custom or usage is only pertinent where the parties are members of a particular vocation, industry, or profession. Rather, "usage of trade" must be understood to encompass any applicable commercial custom, whether it derives from a specific trade or from a broader market in which the parties are involved. (UCC §1.303(c) and Restatement, Second, §222 recognize this by defining "usage of trade" to include any regular practice or method of dealing in a place, vocation, or trade.)

Wolf v. Superior Court of Los Angeles, 8 Cal. Rptr. 3d 649 (Cal. App. 2004), illustrates the role that evidence of trade usage could play in interpreting an agreement. The dispute in that case involved the royalties payable by Walt Disney Pictures and Television to the author of the book on which the movie *Who Framed Roger Rabbit* was based. The agreement between Disney and the author provided that the author would receive a royalty of 5 percent of "gross receipts." The dispute was whether this term meant only cash receipts, or also included the value of other consideration Disney had received from licenses granted for the use of the characters in the movie. The meaning of the term "gross receipts" had to be determined to resolve this dispute. None of the parties to the negotiations had any recollection of ever discussing the meaning of the term. The plain meaning of the words, read in relation to other language in the written contract, suggested that royalties might be confined to cash receipts. However, the author sought to introduce the testimony of an expert that "gross receipts" was generally understood in the movie industry to include noncash consideration, and the court of appeals held that the trial court had erred in refusing to admit the evidence of usage. (The expert did subsequently testify on remand but apparently did not persuade the jury to interpret the term in light of the alleged usage. This case, like *Frigaliment*, shows that even if evidence of usage is offered, its probative weight is ultimately decided by the factfinder.)

Older common law did not recognize any practice as a usage unless it was so firmly established as to be notorious, universal, and ancient. The modern approach is more flexible. Official Comment 4 to UCC §1.303 and Comment *b* to Restatement, Second, §222 explicitly reject any requirement of great longevity and universality and admit the possibility of new usages. The UCC test is simply whether the usage is "currently observed by the great majority of decent dealers." In common law transactions, while some courts may still apply the stricter test, modern common law tends to follow the broader recognition of usage advanced by the UCC and Restatement, Second.

A party who alleges that a usage explains or supplements an agreement must (1) define the trade or market with which the transaction is associated and show the parties' connection to it, (2) prove (usually by expert testimony) that the usage actually exists in the applicable trade or market, (3) show that the usage is pertinent to the dispute in that it relates to the matter on which the parties disagree, and (4) show that the usage is consistent with the express terms of the agreement and has not been excluded by them.

The initial issue of defining the trade or market and showing the relationship of the transaction to that trade or market can be crucial. The determination of the market is sometimes, but not always, straightforward. For example, say the dispute arises from a transaction between a manufacturer of television sets and one of its distributors. Is the relevant market confined to the distribution market for televisions, or is it broader—say the distribution market for home electronics, or for all electronics? Or is the appropriate market wider still, covering the electronics industry as a whole? The choice of the market could be crucial because the existence and nature of usage could be different, or relatively stronger or weaker, if the market is defined more broadly or narrowly.

One of the key factors in defining the trade or market is the parties' relationship to it. If both parties are active participants in the market or trade, usages in that market or trade are readily attributable to their contract, except to the extent that the contract clearly excludes a usage. However, if one of the parties is not involved in the market or trade, its usages should not be relevant to the contract unless the nonmember party knew of the usage and the circumstances show that the parties reasonably expected it to apply to the transaction. As usual, the objective standard is used to decide if a party should be subject to a usage. We are concerned not about whether the party actually knew of and expected the usage to apply but about whether he reasonably should have done so.[5]

Nanakuli Paving and Rock Co. v. Shell Oil Co., 664 F.2d 772 (9th Cir. 1991), illustrates the inquiry into the appropriate market.[6] The case involved a contract between Shell and Nanakuli under which Shell supplied asphalt for Nanakuli's use in paving projects on the island of Oahu. The contract did not have a fixed price term, but provided that the price would be Shell's "posted price at time of delivery." Despite this, Nanakuli claimed that usage in the Oahu paving trade required Shell to "price protect" Nanakuli. That is, where Nanakuli had committed itself to the customer based on a lower posted price

at the time of its bid, Shell would charge Nanakuli that price, even if the posted price at the time of delivery was higher. The court defined the scope of the paving trade broadly to include not only paving contractors but also asphalt suppliers because the suppliers had a close relationship with the pavers and had reason to know of the usage. *Nanakuli* also addressed the issue of whether the alleged usage was consistent with the express terms of the contract. This is important because usage should not be employed to interpret the contract if the parties have indicated the intention to exclude it. If the usage cannot be reconciled with the express terms of the contract, this strongly indicates that the parties did not intend to follow the usage. Because established and applicable usage is such a strong indication of intent, courts usually require the term excluding usage to be very clear and unequivocal. In *Nanakuli*, the court did not find the price protection usage to be inconsistent with the contract's express term that the price was to be Shell's posted price at the time of delivery. Although it is difficult to reconcile these terms, the court found no clear indication that the parties did not intend price protection to qualify the express language of the contract.

§10.1.4 Some General Rules of Interpretation and Construction

When a term is omitted or its meaning is uncertain, this indefiniteness can often be resolved by having recourse to one of a variety of general principles that have been developed by courts as guidelines in the ascertainment of reasonable but unexpressed intent. Many of these rules are based on commonsense inferences, but some are dictated by policy or a perception of fairness. These rules are sometimes called rules of interpretation and sometimes rules of construction—again reflecting the subtle distinction mentioned before. The important point, from a practical standpoint, is that they are guides to enable the court to draw the proper inferences of meaning from whatever facts may be available. Typically, they are used only when there is some uncertainty in the intent of the agreement. They should not be applied mechanically and must take into account the reasonable expectations of the parties and the underlying purpose of the agreement.

There are many rules of interpretation. They are not all of equal strength, and some are more compelling than others. Obviously, they are not all relevant to every case. Although several of the common ones are included here, no attempt is made to catalog them all. These examples sufficiently

illustrate the range and kind of rules covered under this category:

1. If possible, the court should try to interpret an agreement in a way that gives effect to all its terms.
2. Unless the context indicates otherwise, words used in a contract should be given their ordinary, general, or lay meaning rather than a specialized or technical meaning. For example, in *E.M.M.I., Inc. v. Zurich American Insurance Co.*, 9 Cal. Rptr. 3d 701 (2004), a jeweler's insurance policy excluded coverage where jewelry was stolen from a vehicle unless the jeweler's representative was "in or upon the vehicle" at the time of the theft. The jewelry was stolen from the car while the salesman was checking the car's tailpipe. The insurer argued that the term "in or upon" was used in a technical sense to mean that the insured must actually be in the vehicle, not just next to it. The court disagreed. If the insurer intended to use a term in a technical sense, it should so indicate, say by defining the term in the policy. Because the term "upon" was ambiguous, it should be interpreted in a sense that accords with the insured's reasonable expectation that the exclusion applies only where the car is unattended. *Meridian Leasing, Inc. v. Associated Aviation Underwriters*, 409 F.3d 342 (6th Cir. 2005), followed the same approach in finding that an insurance policy on an aircraft covered damage to the engine when it caught fire upon being started. The insurance policy excluded damage caused by "wear and tear" and the insurer argued that the exclusion for "wear and tear" should be broadly understood to restrict coverage to damage from an accident and to exclude damage resulting from a mechanical problem. The court disagreed. The policy had no technical definition of "wear and tear." In ordinary usage, a fire caused by mechanical fault is not "wear and tear," which means deterioration resulting from the ongoing operation of the plane.
3. The rule *Ut res magis valeat quam pereat* means "The thing should rather have effect than be destroyed." If one interpretation would make the contract invalid and another would validate it, the court should favor the meaning that validates the contract. In the same spirit, a court should prefer an interpretation that would make a term reasonable and lawful over one that would have the opposite effect

and should prefer an interpretation that positively rather than negatively affects public policy or the public interest. For example, say that a partnership agreement, entered into in New York City, contains a covenant not to compete. This covenant states that a partner will not engage in a competing business "in New York" for a period of two years after leaving the partnership. Agreements that stifle competition and restrict a person's ability to earn a living are unenforceable as against public policy unless they are reasonable in scope.[7] A partner leaves the partnership and sets up a competing business a few blocks away. She claims that the covenant is unenforceable because it is overbroad and unreasonably extends to the entire state of New York. The partnership contends that it is not unreasonable because it is intended to cover only to the city of New York. There is no extrinsic evidence from which the court can determine the intended meaning of "New York." Therefore, if the more restrictive meaning would save the covenant from invalidity, the court will favor that meaning.

4. Specific or precise provisions should be given greater weight than general provisions. For example, one clause in a lease says, "No pets may be kept on the premises." However, there is another provision in the lease that says, "Guide or service dogs shall be kept on leashes at all times in the public areas of the building." The specific provision concerning guide and service dogs makes it clear that the general rule on keeping pets on the premises does not apply to them.
5. Where an agreement consists of both standardized and negotiated terms (or preprinted and handwritten or typed terms), any conflict between them should be resolved in favor of the negotiated, handwritten, or typed terms.
6. The rule of *ejusdem generis* ("of the same kind") holds that when specific and general words are connected, the general word is limited by the specific one, so that it is deemed to refer to things of the same kind. For example, a lease states that "skateboards, roller skates, rollerblades, and other means of locomotion are prohibited in common areas and hallways." The common denominator here is that all these items make use of wheels under the feet. On this reasoning, the general words "other means of locomotion" do not include wheelchairs or motorbikes. However, if the common denominator is

taken to be wheels, these two items would be included in the general language, but a camel would not be.

7. The rule of *noscitur a sociis* (“known from its associates”) is similar to *ejusdem generis* but is not confined to linked general and specific words. Whenever a series of words is used together, the meaning of each word in the series affects the meaning of others. For example, if a term in a lease provides that “no dogs, cats, or primates may be kept on the premises,” the meaning of “primates” is qualified by the others. It would therefore cover only primates in the sense of apes and monkeys and would not forbid the lessee from having his uncle, a bishop, move in with him.
8. The rule *Expressio unius est exclusio alterius* means “The expression of one thing excludes another.” This is in some sense the opposite of the *ejusdem generis* rule. When a thing or list of things is specifically mentioned without being followed by a general term, the implication is that other things of the same kind are excluded. For example, a term that prohibits “dogs, cats, and primates” impliedly does not prohibit ducks.
9. The *contra proferentum* rule (stated in full, *omnia praesumuntur contra proferentum*) means “all things are presumed against the proponent.” When one party has drafted or selected the language of an unclear provision, the meaning is preferred that favors the other party. This rule is often said to be a tie breaker, in that it should be used as a last resort when no more direct and pertinent guide to meaning is applicable. It is not always used as a last resort, however, and tends to be much favored when the proponent of the terms is a party with relatively strong bargaining power who has produced a preprinted standard form for the other’s signature. The *E.M.M.I* and *Meridian Leasing* cases in item 2 above both demonstrate this approach to the interpretation of an insurance policy. Insurance policies are prime examples of standard form contracts that are fertile ground for application of the *contra proferentum* rule.

§10.2 GAP FILLERS USED TO EFFECTUATE THE PARTIES’ REASONABLE INTENT

§10.2.1 Introduction

A gap filler is a provision legally implied into a contract to supplement or clarify its express language. As its name suggests, the principal purpose of a gap filler is to supply a logically inferable contract term when it is clear that the parties intended a contract, but have failed to provide adequately or at all for the question in issue. Of course, some apparent gaps in an express agreement could be filled by contextual evidence, so a legally implied gap filler is usually used only when no pertinent contextual evidence is available to establish the existence of a term as a matter of fact. Gap fillers are therefore standard terms supplied by law. Some have been developed by courts and others are provided by legislation. Courts and legislatures do not pick them out of the air but base them on common expectations, commercial practice, and public policy. For this reason, standard terms supplied by law are meant to reflect what the parties likely would have agreed had they discussed the issue. As this description indicates, when a court resorts to legally implied gap fillers, it is usually engaged in construction, rather than fact-based interpretation.

For example, Buyer agrees to buy Seller's house, subject to Buyer being able to secure the necessary financing. Nothing is said in the written agreement or in the negotiations about Buyer having the duty to make a conscientious effort to obtain the financing. If Buyer does nothing to seek financing, he will likely be held to have breached a legally implied promise to make reasonable efforts to apply for and secure the financing. The implication of such a promise is a logical extension of the express provisions of the agreement and gives effect to the presumed intent of the parties. It recognizes that they probably did not contemplate that Buyer could slip out of his obligations simply by not bothering to apply for a loan. In this way, the implied term constructs what the parties must have intended, had they been acting fairly and reasonably, and it gives effect to their reasonable expectations and to the underlying purpose of the agreement. Because legally implied terms are derived from and known in the market, there is commonly an affinity between legally implied terms and usage. Therefore, this same term requiring best efforts in seeking a loan could probably have been established by evidence of the customary practices pertaining to the sale of a home subject to the contingency of financing. However, the difference is that if a usage is so well established that it has reached the point of being

recognized as a legal standard term, it becomes part of the contract as a matter of law, not of fact. It is therefore not necessary to establish it by evidence.

Some gap fillers are well established and others have been recognized more recently. Additional ones will continue to develop in the future as new legal implications are drawn from changing market expectations. Of course, there cannot be standard terms for every conceivable gap, so there are some omissions that cannot be cured by legal implication. Some gap fillers supply generalized obligations that are likely to be implied in all kinds of contracts, and some are very specific, relating to particular types of term in specialized contracts. The following samples of general and specific gap fillers illustrate their range and nature.

§10.2.2 Gap Fillers That Supply General Obligations

When a contract does not clearly specify a level of performance but it is clear that the parties' purpose can be achieved only if the obligor puts some energy and dedication into the performance, the law implies an obligation to make best efforts or reasonable efforts[8] to effect the contract's purpose. The above example of the house sale subject to financing illustrates this. Another illustration is provided by *Wood v. Lucy, Lady Duff-Gordon*, 222 N.Y. 88 (1917), discussed in sections 10.1.1 and 7.9.2, in which the court found that an exclusive distributorship contract impliedly required the distributor to make best efforts to sell the product. This general principle is likely to apply in any type of contract under which the grantor of a license, distributorship, or dealership relies on the conscientiousness of the grantee to market a product effectively. The facts and resolution of *B. Lewis Productions, Inc. v. Angelou*, 2005 WL 1138474 (S.D.N.Y. 2005), are strikingly similar to *Wood*. The poet Maya Angelou entered into a written agreement with Lewis under which she granted him the exclusive right to represent her in placing her work in greeting cards, calendars, and other stationery items. Lewis agreed to contribute "all the capital necessary" and Angelou agreed to contribute "original literary works." The agreement did not particularize Lewis's duties, but it did provide that the parties would share the net profits of the venture after revenue had been applied to the repayment of Lewis's capital contribution and expenses. Lewis began work immediately. Just over two years after the agreement was entered, and when Lewis was close to

executing a licensing agreement with Hallmark cards, the personal relationship between the parties soured, and Angelou terminated the agreement. Shortly thereafter, Angelou entered into a licensing agreement with Hallmark on her own. Protracted litigation followed in which Lewis sued Angelou for breach of contract. The court, quoting from *Wood* at length, noted that like Wood and Duff-Gordon, Lewis and Angelou unquestionably intended to form a business relationship in which each party assumed obligations. Rather than defeat this intent by declaring the contract to be too indefinite to enforce, the court followed the approach of *Wood* and supplied an obligation of good faith and fair dealing to give content to the vaguely expressed undertakings of the parties.

The problem with the legal implication of broad, generalized obligations is that they are vague in themselves. Therefore, although they may go part of the way in curing a vagueness or omission in the agreement, they may not settle the scope and content of the obligation. That is, a concept such as "best efforts" is mushy and nonspecific, so that it is not enough simply to imply the obligation. The further step must be taken to determine with some precision what degree of effort is required by the obligation. It may be easy to find a breach when no effort is made at all, but more clarity is needed to decide if some greater degree of effort is an adequate performance. To define the obligation more acutely, a further inquiry must be made into the underlying purpose of the contract and the reasonable expectations of the parties.

§10.2.3 Gap Fillers That Supply More Specific Rights and Duties

Both the UCC and the common law supply gap fillers that relate to specific aspects of particular kinds of contracts. Some of these are concrete and precise, but others include generalized concepts, such as reasonableness, that present interpretational problems similar to those discussed above. The following selection illustrates the kind of supplementary terms available to fill gaps left by the parties. These are merely random examples. No attempt is made to be comprehensive. Remember, they are used only if the contract has a gap or uncertainty that has not been resolved by contextual evidence.

The common law has developed many gap fillers through the process of judicial decision. Three examples, discussed elsewhere in this book, are enough to illustrate this point. First, if the parties to an employment contract do not specify its duration, it is deemed to be terminable at will. (*See* section

8.10.) Second, if the parties do not state that rights under a contract are personal to the obligee, the obligee may transfer (assign) those rights to another person. (*See* sections 12.9 and 19.3.3.) Third, if the contract does not provide for the sequence of performance, it is presumed that when both performances are a single instantaneous act, they must be made concurrently. But if one performance is instantaneous and the other needs time to perform, it is presumed that the longer performance must take place first. Therefore, in the sale of a house, unless otherwise stated in the contract, it is implied that transfer of title and payment occur at the same time, but in a contract to build a house, the builder must complete the construction before the owner has to pay. (*See* section 16.8.4.)

UCC Article 2 also has a number of gap fillers. Because they are set out in the statute, they are easier to find than those provided by common law. For example, unless the agreement expresses otherwise, §§2.312, 2.314, and 2.315 imply certain minimum warranties that a seller makes under defined circumstances regarding the title to and quality of the goods; if the parties do not specify the price of the goods, §2.305 infers that they agreed to a reasonable price unless the apparent intent of the agreement is otherwise; if payment terms are not expressed, §§2.307 and 2.310 assume that payment must be made upon delivery of the goods; §§2.307, 2.308, and 2.309 require that the goods be delivered in a single lot at the seller's place of business within a reasonable time; in a requirements or output contract,[9] §2.306(1) implies both a good faith and a reasonableness obligation on the party who is to determine the quantity of goods ordered or supplied; and §2.306(2) implies an obligation of best efforts on both parties when the contract imposes an obligation on one of them to deal exclusively with the other.

§10.3 TERMS CONSTRUED AS A MATTER OF POLICY

§10.3.1 Supplementary Terms That Cannot Be Excluded by Agreement

There is an exception to the general rule, stated in section 10.2, that terms supplied by law are intended to bring out the perceived reasonable intent of the parties and will not be included in the contract unless consistent with that intent. Some legally implied obligations are so fundamental to fair dealing or

so strongly demanded by public policy that they are mandatory and are part of the contract irrespective of the parties' actual intent. Even if they wish to, the parties cannot effectively agree to exclude such a term.

Construed terms of this kind are not properly called gap fillers. They are not default rules, but enter the contract whether or not there is a gap or uncertainty about the parties' intent. Although such strongly construed terms are raised here as part of the discussion of the process of finding meaning in agreement, they are more a matter of regulation than of seeking intent. The law's true purpose in such a firm imposition of standard terms is not so much to ascertain what the parties reasonably must have intended, but to limit contractual autonomy in the interest of public policy. Sometimes the policy in question is not directly related to contract law, but is concerned with the undesirable effect of particular contract terms on some other field, such as tort, antitrust, or criminal law. Often, however, the underlying public policy is that of protecting a weaker party from one-sided and unfair terms. In this respect, mandatory construed terms are part of the broader subject of regulating the formation and content of contracts, discussed in Chapter 13.

§10.3.2 The General Obligation of Good Faith and Fair Dealing

One of the most important and pervasive mandatory construed terms is the general obligation of good faith and fair dealing that the law imposes on both parties in the performance and enforcement of the contract. Whether or not the agreement expressly articulates this obligation, and even if it expressly excludes it, the law implies it into every contract. This duty is recognized in both UCC §1.304 and Restatement, Second, §205.

It is one thing to recognize a general obligation of good faith and fair dealing, but quite another to give specific content to these broad and abstract concepts when one of the parties claims that the other's conduct breached the obligation. We encounter this question in section 7.9.3 when discussing the obligation of good faith imposed by UCC §2.306 on buyers and sellers in output and requirements contracts. We see there that the determination of whether a party acted in good faith must be made with reference to the reasonable expectations of the parties in the context of the transaction. Even narrowing the concept to the reasonable expectations of the parties does not make it easy to apply, and the question of whether some conduct violated the obligation can be difficult and a matter of strong disagreement.

For example, in *United Airlines, Inc. v. Good Taste, Inc.*, 982 P.2d 1259 (Alaska 1999), United entered into an in-flight catering contract with Good Taste. To perform the contract, Good Taste had to expand its capacity extensively, incurring $1 million in costs to enlarge its operation. The period of the contract was three years, but the contract provided that either party could terminate it on 90 days' notice. After about one year, United exercised its right to terminate the contract by giving the 90 days' notice. The reason it terminated was because it had decided to use another company for its in-flight catering. Good Taste claimed that United had violated its obligation of good faith by terminating the contract. It contended that it would not have spent the money to expand its operations had it not had a reasonable assurance of a three-year contract, and that United's representative had told it that United would not use the termination provision unless it stopped flying to Alaska. Because the termination provision had no qualification, the majority of the court interpreted it as allowing termination at will, without any requirement of cause. The majority recognized that this contract, like every contract, contained an implied covenant of good faith and fair dealing. However, it granted summary judgment to United because it refused to find that United had violated this obligation merely by exercising a clear and unambiguous termination right. The obligation of good faith precludes a party from opportunistic advantage-taking and actions motivated by malicious or improper motives (such as the intent to drive the party out of business). However, where the contract contains an at-will termination clause, the obligation of good faith and fair dealing does not preclude exercise of that right to terminate, even if motivated by the purpose of getting a better deal elsewhere. To so hold would convert the contract's clear at-will termination right into one that required cause for termination. A dissenting justice argued that the termination clause did not expressly state that United could terminate at will, but was silent on the question of whether United needed to show cause for cancellation. Therefore, the termination clause must be read in light of the obligation of good faith, to be determined in light of the parties' reasonable expectations. The parties understood that Good Taste would not have made a significant investment in its facilities unless it had some assurance that United would not simply terminate the contract if a better deal came along. United's termination without cause violated Good Taste's reasonable expectations, and the case should go to trial so that a jury could decide if this constituted a violation of United's obligation of good

faith.

§10.3.3 Construed Terms That Can Be Excluded Only by Express or Specific Language

Below the level of absolute legal implication, there are construed terms that are important enough to be more strongly implied than other gap fillers. Although public policy does not preclude the parties from contracting out of them, it requires the intent to exclude them to be clearly expressed. Stated differently, while most gap fillers enter the contract only when necessary to resolve an uncertainty or omission, there are some that are so strongly implied as a matter of policy that they become part of the contract unless its express terms clearly exclude them. In some cases, even a clear exclusion is not good enough unless it complies with specified rules that may prescribe the use of particular language or format.

For example, UCC Article 2 has a policy in favor of providing warranties in certain types of sales of goods. Therefore, although §2.316(2) allows the seller to contract out of them, it recognizes a warranty disclaimer as effective only if it satisfies certain formalities. To disclaim the merchant[10] seller's warranty of merchantability (that is, that the goods meet minimum trade standards), the sales contract must mention "merchantability" and, if in writing, the disclaimer must be conspicuous. When goods are sold for a particular purpose, the seller gives an implied warranty of fitness for that purpose unless it is disclaimed conspicuously in writing. The goal of these rules is to make it more likely that the buyer notices the disclaimer, and to prevent the seller from hiding it in a mass of boilerplate.

§10.4 THE PROBLEM OF INDEFINITENESS IN AN AGREEMENT

If the terms of an agreement are expressed clearly and comprehensively, the fact of contract formation and the extent of each party's commitment can be ascertained with relative ease by the interpretation of their language in context. However, parties sometimes fail to express their assent adequately because they have left a material aspect of their agreement vague or

ambiguous, or they have failed to resolve it or to provide for it at all. When the agreement suffers from this kind of uncertainty, it is said to be indefinite.

There could be many different causes of indefiniteness. For example, the parties may not take the trouble of discussing all aspects of the proposed relationship, they may not give enough attention to detail, they may be unclear in their thinking or articulation of what is expected, or they may avoid confronting thorny issues that threaten to collapse the deal. Sometimes it is clear that the parties genuinely intended a contract despite the indefiniteness, but in other cases the lack of resolution means that they had not yet achieved consensus.

The general rule is that no contract comes into being if a material aspect of the agreement is left indefinite by the parties and the uncertainty cannot be resolved by the process of interpretation or construction. The existence of such an irresoluble key aspect of the relationship means that the parties never reached sufficient consensus to conclude an enforceable contract, and the court should not try to concoct a contract for them.

This statement of the general rule suggests two central issues that must be confronted in dealing with problems of indefiniteness: First, for an apparent contract to fail for indefiniteness, there must be an incurable uncertainty about what the parties agreed to, so that their intent to enter a contract is in doubt, or the court is at a loss in establishing a basis for enforcing what was agreed. This first issue involves many considerations that form the basis of the remainder of this chapter. Second, the uncertainty must relate to a material aspect of the relationship. Although an indefinite nonmaterial term does need to be settled by the court if it is relevant to the dispute, the uncertainty does not preclude contract formation.

A term is material if it is an important component of the contract. It is so central to the values exchanged under the contract that it is a fundamental basis of the bargain.[11] Although materiality is sometimes obvious, it is not always easy to decide because the significance of a term in any particular relationship can be gauged only by interpreting the agreement in context to uncover the reasonable expectations of the parties.

Although a court should not find a contract where indefiniteness is severe enough to indicate a lack of assent to its material terms, this does not mean that the court should refuse contractual enforcement unless every material term of the agreement has been expressed with piercing clarity. Such a rigorous standard would err in the opposite direction by failing to recognize

a contract when the evidence suggests that the parties reasonably expected to be bound, did intend to enter a contract despite the indefiniteness, and had relied on the existence of a contract.

The balance between these poles results in a general principle that tolerates some degree of indefiniteness provided the evidence indicates that the parties did intend a contract, and there is some means of resolving the uncertainty, so that a breach can be identified and a remedy provided. Both UCC §2.204(3) and Restatement, Second, §33(2) adopt this approach by emphasizing that a contract should be treated as reasonably certain if the language of agreement, interpreted in context and in light of applicable legal rules, provides enough content to establish an intent to contract, a basis for finding breach, and a means of providing a remedy.

Although remedies are not discussed until Chapter 18, it is useful to focus on the relationship between definiteness and remedy suggested by Article 2 and Restatement, Second. Definiteness is not absolute but relative, and the degree of certainty required may be different depending on the nature of the controversy and the relief claimed. For example, if the plaintiff claims enforcement of a clear obligation due by the defendant, and the defendant contends that the contract is too indefinite because of vagueness in the plaintiff's obligation, the court does not have to establish the plaintiff's obligation with as much certainty as it would have to do if that was the obligation in issue. Similarly, if the plaintiff is claiming damages for the breach of an unclear obligation of the defendant, the court needs just enough information to determine a monetary award. However, if the plaintiff was seeking specific performance of the obligation (that is, a court order compelling the defendant to perform the contract), the court would need a greater degree of certainty to grant the order because the court must be able to define the obligation clearly if it is going to order its performance.

Although it is relatively easy to identify the general range of appropriate judicial intervention to cure indefiniteness, it is much more difficult to know if an individual case falls within that range—that is, whether the indefiniteness is properly remediable or should preclude contractual enforcement. As in so many other situations, the answer can be reached only by finding the mutual intent of the parties through the process of interpretation and construction.

§10.5 DIFFERENT CAUSES AND FORMS OF INDEFINITENESS

Indefiniteness in an agreement could be caused by vagueness, ambiguity, omission, or irresolution. These different shortcomings have much in common, but they may raise different concerns that call for separate treatment. It is therefore useful to begin by articulating this distinction.

§10.5.1 Unclear Terms: Vagueness and Ambiguity

a. Vague Terms

A term is vague (or uncertain) if it is stated so obscurely or in such general language that one cannot reasonably determine what it means. For example, Lessor agrees to let certain business premises to Lessee for one year in exchange for "a periodic rental payment based on a fair percentage of Lessee's earnings." One cannot determine on the face of this language the amount and the due date of the rent. The wording fails to convey a certain and concrete meaning. *Baer v. Chase*, 392 F.3d 609 (3d Cir. 2004), provides another illustration of incurable vagueness. Baer, an ex-prosecutor and would-be screenwriter, assisted Chase, the creator of the hugely successful series, *The Sopranos*, by helping him with background information on the New Jersey mob and by reading and commenting on his draft script. Baer asserted that Chase had agreed orally that if the show became a success, he would "take care" of him and would reward him "in a manner commensurate with the true value" of his services. The court of appeals affirmed the trial court's grant of summary judgment against Baer on the contract claim. It held that even if such a promise was made, these terms were too indefinite to enable the court to ascertain with reasonable certainty what performance was to be rendered by Chase. The court acknowledged that indefiniteness can sometimes be resolved by the implication of a term, such as a reasonable price. However, the vagueness in this undertaking was beyond cure.[12]

By contrast, the court did not find indefiniteness to be fatal in *B. Lewis Productions, Inc. v. Angelou*, discussed in section 10.2.2. Recall that Maya Angelou granted to Lewis the exclusive right to represent her in placing her work in greeting cards, calendars, and other stationery items. Lewis agreed to

contribute “all the capital necessary” and Angelou agreed to contribute “original literary works.” The agreement did not set out Lewis’s duties, but it did provide that the parties would share the net profits of the venture. About two years after the agreement was made, and just as Lewis was about to secure a licensing agreement with Hallmark cards, Angelou terminated the agreement because of personal differences with Lewis. Angelou ultimately entered into a licensing agreement with Hallmark on her own. Lewis sued Angelou for breach of contract.[13] Angelou moved for summary judgment on the ground that the agreement was too indefinite to be enforced as a contract. The court denied her motion. It noted that the court’s role was not to make a contract for the parties, and it would not enforce an agreement whose terms are so indefinite that the parties’ intentions cannot be ascertained with reasonable certainty. However, it observed that courts are reluctant to strike down contracts for indefiniteness and cautioned that courts should not turn the search for certainty into a “fetish.” Some degree of indefiniteness can be found in most contracts. The court recognized that the parties did intend to form a business relationship, and it felt that all of the open-ended terms could be given adequate content by supplying a standard of reasonableness and good faith to the parties’ undertakings.

b. Ambiguity

A term is ambiguous if it is capable of more than one meaning. Ambiguity can lie in a word itself or in the structure of a sentence. Ambiguity in a word may be illustrated by a term in a lease that confines the use of the premises to “the purpose of conducting a bookmaking business.” The word “bookmaking” could refer either to the manufacture of books or to the making and placing of bets on horses and sporting events. Ambiguity can also result from inept sentence construction. For example, although the lease makes it clear that “bookmaking” is used in the latter sense, it goes on to provide that Lessor “shall be entitled to 10 percent of Lessee’s profits from all gambling activities that shall be lawfully conducted on the premises.” The clumsy sentence construction may mean that Lessor is entitled to 10 percent of all profits earned by Lessee from gambling, and that Lessee is obliged to conduct only lawful activity on the premises, or it may mean that Lessor is entitled to 10 percent of the profits from lawful gambling but gets no share of illegal gambling proceeds.

Ambiguity in language must be distinguished from a dispute over the application of unambiguous language to a particular set of facts. The court made this distinction in *Psenicska v. Twentieth Century Fox Film Corp.*, 2008 WL 4185752 (S.D.N.Y. 2008), *aff'd* 409 Fed. Appx. 368 (2d Cir. 2008). The case involved the movie *Borat*, in which the character, a fictional Kazakh television reporter, tours America with the apparent purpose of making a documentary on American life. The movie is a comedy, and its particular brand of humor (described by the court as "childish and vulgar") is to dupe ordinary people (that is, members of the public who are not actors) into believing that they are participating in a documentary film. As the filming proceeds, the documentary character of the film deteriorates into chaos as the Borat character engages in surprising, outrageous, and offensive conduct. Several of the people set up in this way sued the studio for damages for the use of their images in the movie. Each had signed an agreement consenting to appear in a "documentary-style motion picture," and the studio therefore moved to dismiss their suits on the basis of this consent. The plaintiffs argued that dismissal was not appropriate because the consent was too indefinite to enforce, in that the term "documentary-style motion picture" was ambiguous. The court disagreed. The dictionary definition of the words "documentary" and "style" make it clear a "documentary-style movie" is "a work displaying the characteristics of a film that provides a factual record or report." None of the parties challenged this dictionary-based definition, and the court held that while the film was a parody, it was set up in a style that made it look like a documentary. The court therefore dismissed the suits.

c. Curing Vagueness or Ambiguity with Contextual Evidence

A term that is not readily comprehensible on its face may not be incurably vague or ambiguous, because it may become clear if interpreted in context. Evidence of what the parties said or did in negotiations, correspondence, or dealings prior to the agreement or during the period following it may help clarify what they meant by the language used. In addition, clarity may be supplied by a custom or usage in the commercial environment in which the parties made the agreement, or by standardized terms recognized by law. We will shortly turn to these matters in detail. For the present, simply note that language that seems vague or ambiguous in isolation may become more certain if interpreted in the wider environment of the transaction. In the first

example above, the vague rental provision may not be as unclear as it sounds if its meaning is embellished by facts in the context. Say, for example, that these clauses are regularly used in the commercial real property market, in which "fair rental" is widely understood to be based on an index published by an association of landlords, and rent is customarily paid monthly in advance. Similarly, the ambiguous word "bookmaking," while unclear in isolation, may become more definite if other provisions in the lease, discussions during negotiations, or other facts are available to show what the parties meant.

But contextual evidence cannot always save a vague or ambiguous term. Sometimes unclear language defies interpretation, even in context, because the circumstances of the transaction are devoid of helpful indicators of meaning. If a central component of an apparent agreement suffers from this degree of incurable indefiniteness, one can only conclude either that no contract was intended or, if it was, that the parties failed to form a clear intent or failed to communicate it well enough to create an enforceable relationship.

d. Plain Meaning or Contextual Ambiguity

While an unclear term can be clarified by contextual evidence, the opposite may also be true: A term that seems clear on its face may turn out to be ambiguous if viewed in the context of the transaction. If the plain meaning of words is clear at face value, some courts, particularly in older cases, refuse to go behind that plain meaning to examine contextual evidence that may undermine the plain meaning. This focus on plain meaning is sometimes called a "four corners" approach because the court looks for meaning within the four corners of the document.[14] Most modern courts do not favor a plain meaning approach where there is contextual evidence that has relevance to the possible meaning of the words used. They recognize that words do not always have a single, fixed meaning. To base interpretation of the parties' intent on nothing more than the apparent meaning of words is too rigid and may lead the court to a literal interpretation that the parties did not intend. Therefore, if extrinsic evidence is available to cast light on the meaning of language, most modern courts are willing to take it into account in determining what the parties intended. This is known as the contextual approach to interpretation. This does not mean that the court will ignore the plain meaning of the parties' language or that it will ultimately be persuaded to reach an interpretation contrary to the evident plain meaning of the

language. The probity of contextual evidence is dependent on the clarity with which the parties have chosen to express their intentions and the degree to which the meaning suggested by the context is consistent with the language used by the parties.

Pacific Gas and Electric Co. v. G. W. Thomas Drayage & Rigging Co., 442 P.2d 641 (Cal. 1968), is a landmark in the development of the principle that the words used by the parties must be interpreted, not at face value, but within the entire context of the transaction. A provision in a contract to repair machinery provided that the repairer would "indemnify" the owner "against all loss, damage, expense, and liability resulting from…injury to property" arising in the performance of the contract. The repairer damaged property belonging to the owner. The owner claimed that the indemnity made the contractor liable for this damage, but the contractor argued that the provision was intended to apply only to damage to property of third parties. The trial court interpreted the language of the provision solely at its face value and concluded that its plain meaning did not restrict the repairer's liability to damage to the property of third parties. The Supreme Court reversed the trial court's decision because the trial court had refused to admit extrinsic evidence offered by the repairer (such as evidence of admissions by the owner and prior practices of the parties) that allegedly showed that the parties intended the indemnity clause to apply only to damage to the property of third parties. The court emphasized that the purpose of interpretation is to determine the intent of the parties, which cannot be done if the court refuses to look beyond the meaning of the words as the judge understands them. Words are just symbols of thought, and the context in which they are used can affect their meaning.

The court applied the principles set out in *Pacific Gas* in *Wolf v. Superior Court of Los Angeles County*, discussed in section 10.1.3. Recall that the case involved a dispute over royalties between Walt Disney Pictures and Television and the author of the book on which the movie *Who Framed Roger Rabbit* was based. The agreement under which Disney had bought the rights to the book provided that the author would receive a royalty of 5 percent of "gross receipts." The author claimed that "gross receipts" included the value of consideration, other than cash, that Disney had received from licenses granted for the use of the characters in the movie. The author sought to admit the testimony of an expert that trade usage in the movie industry supported the broader interpretation, but the trial court refused to admit the

evidence on the ground that the term (interpreted in light of the writing as a whole) was unambiguous on its face and covered only cash receipts. On the basis of this conclusion, the trial court granted Disney's motion for summary judgment. Citing *Pacific Gas*, the court of appeals reversed the summary judgment and remanded the case for trial, holding that the trial court erred in refusing to consider extrinsic evidence that could show that the term was in fact ambiguous.[15]

Pacific Gas represents a judicial approach that is most receptive to contextual evidence to elucidate the meaning of apparently clear and unambiguous language. However, some courts are more wary of resorting to contextual evidence where there is no facial ambiguity in the language of the contract. For example, in *Wilson Arlington Co. v. Prudential Ins. Co. of America*, 912 F.2d 366 (9th Cir. 1990), the court criticized the broad definition of ambiguity in *Pacific Gas*, which it felt allowed a party too much leeway in creating ambiguity in contract language that is not reasonably understood in more than one way.

§10.5.2 Omitted Terms

If a term is omitted, it simply is not there. The agreement has a gap regarding that particular aspect of the relationship. Say that Lessor and Lessee discussed and wrote out most of the terms of the lease, but did not address the amount of the rent orally or in writing. This could mean that they failed to reach agreement on this crucial term, so that no lease came into being. However, it could also mean that the parties did not consider it necessary to articulate the amount of the rent, because they intended that the rent would be reasonable, based on the fair market rental for commercial property of this kind. In other words, the apparent gap in their agreement may indicate not a lack of consensus, but an intent to adhere to some "off-the-shelf" market or legal standard that they thought of as too obvious to need articulation. To decide which of these two possibilities is the right one, their intent must be determined by looking at the language of the agreement as a whole in light of all the circumstances of the transaction.

§10.5.3 Terms Left for Future Determination

a. Unresolved Terms and "Agreement to Agree"

An unresolved term differs from a vague or unarticulated term in that the parties have not yet settled it, leaving it to be resolved by agreement at some later time. Where parties deliberately postpone agreement on a material term, it cannot be said that they have yet formed a contract, even if they have reached consensus on all the other terms of their relationship. Where the parties agree in principle that they will make a contract, but they have not yet settled a material term, courts sometimes describe their understanding as an "agreement to agree," which is not yet a contract and cannot be enforced. *Joseph Martin Jr. Delicatessen, Inc. v. Schumacher*, 417 N.E.2d 541 (N.Y. 1981), illustrates the approach to an "agreement to agree." A renewal option in a lease gave the tenant the right to renew the lease for an additional five-year period at "annual rental to be agreed upon." The court found this to be an unenforceable "agreement to agree" because the parties had not agreed to the rent for the renewal period and had merely postponed agreement on that term to a future date. The court noted that the parties could have entered into an enforceable contract without fixing the actual amount of the rent, had they provided some standard or formula for determining the rent in the renewal period, or if they had agreed to base the rent on a reasonable or market standard. However, they had not done this. A dissent in the case shows that it can sometimes be a difficult question of interpretation to decide whether the parties actually deferred agreement or, instead, that they agreed to have the open term settled by a market standard. The dissent argued that because it was clear that the parties intended to create a binding renewal option, the better interpretation was that they had agreed to a renewal at a reasonable rent based on the market rent for the premises at the time of renewal. On this interpretation, the parties made an enforceable contract because they did not defer agreement, but instead settled on an objective standard for fixing the future rent. Restatement, Second, §33, illustration 8 recognizes this distinction. It states that a provision for future agreement on price strongly indicates a lack of intent to be bound, but if the parties manifest intent to be bound, the court should determine a reasonable price.[16]

b. Determination by an Objective Standard

As noted above, we must distinguish an unenforceable "agreement to agree,"

which is not yet a contract, from a contract in which an omitted or apparently unsettled term can be resolved by a gap filler or by applying a formula or objective standard. If the parties do not actually defer agreement, but instead agree, expressly or by implication, on some means of settling the term without the need for later agreement between the parties, they have entered into an enforceable contract. The open term can be resolved under the prescribed standard. Where the parties do not make it clear whether their intent is to defer agreement or to resort to a determinate standard for fixing the term, a court must glean their intent by interpretation or construction. As *Joseph Martin Jr. Delicatessen* shows, this can be a difficult question to resolve, and different judges could reach contrary interpretations.

Say, for example, that Owner has completed the plan for a new commercial building and construction is about to begin. Owner has been negotiating with Lessee for a lease of space in the building upon its completion. The parties have reached agreement on the period of the lease, the location and size of the premises, and all other terms—except for the rent to be paid. They wish to enter the lease agreement now, even though the premises will not be ready for occupation for two years. However, neither wishes to agree to a set figure because they do not know what the rental market will be like when the building is completed. We have seen that the parties are not able to bind each other to the lease now if they simply agree to resolve the question of rent closer to the time of occupation. However, they can enter into a binding contract now, even without settling the amount of the rent, if they identify some formula or external source or standard that will allow the rent to be determined by some objective criterion at the appropriate time in the future. For example, they could provide for the rent to be calculated by applying a published economic indicator to a base figure, or they could base the rent on a market standard derived from average rent charged for comparable buildings in the area at the time of occupation, or they could provide for market-rate rent to be set by an independent arbitrator. *Feldman v. Google, Inc.*, 513 F. Supp. 2d 229 (E.D. Pa. 2007),[17] provides a good example of a valid future pricing formula. The price term in the contract for advertising on the Google site provided a pricing formula that would set the price of the advertising based on the number of clicks on the advertisement—the more people who clicked on the ad, the higher the rate charged to the advertiser. The court found this to be a practicable method of determining price with reasonable certainty, based on ascertainable objective

data.

Of course, the formula or objective standard must itself be clear, so the parties must at least be able to agree now on what criterion should be used. One of the best examples of an incomprehensible formula can be found in *Walker v. Keith*, 382 S.W.2d 198 (Ky. 1964). The renewal option in a lease expressed the rent payable for the renewal period in the following exquisite prose: "[R]ental will be fixed in such amount as shall actually be agreed upon by the lessors and the lessee with the monthly rental fixed on the comparative basis of rental values as of the date of the renewal with rental values at this time reflected by the comparative business conditions of the two periods." Unsurprisingly, when the time for renewal arrived, the parties disagreed on the meaning of this language. The court held that the parties had not entered into a renewal contract because the incoherent language did not set out any kind of workable formula or objective standard for calculating the rent, and there was no basis to assume that the parties meant to contract for a reasonable rent.

c. Determination Within the Discretion of One of the Parties

The parties may decide to leave the determination of an open term to the discretion of one of them. If this is done, there is no problem with deferred agreement, because the parties have committed to this method of settling the term and will not have to try to reach agreement on it at a future time. For example, in the above illustration involving the lease of premises, the parties could have agreed that the rent would be set by the lessor in its reasonable discretion. Of course, the lessee takes a risk in deferring to the lessor's discretion, but the lessor's obligation to act reasonably provides the lessee with some measure of control over the exercise of discretion. (We see in section 7.9 that even in the absence of an express undertaking to set the rent reasonably, a court will readily imply either a good faith or a reasonableness standard to restrict the lessor's discretion.)

The court upheld a term allowing one of the parties to set the price in *Arbitron, Inc. v. Tralyn Broadcasting, Inc.*, 400 F.3d 130 (2d Cir. 2005). Arbitron provided listener demographics data used by radio stations to attract advertisers. It entered into an agreement with Tralyn, the owner of a radio station, under which Arbitron granted a five-year license to Tralyn to use these reports. The agreement provided that if Tralyn acquired additional radio

stations or assigned the license to a successor that owned additional stations, Arbitron had the right to increase the license fee. It did not specify the amount of the increase or provide a standard for determining it. About two years later, Tralyn was bought by a corporation that owned four other stations and it assigned the license to the buyer. Arbitron increased the license fee. When neither Tralyn nor its buyer paid the increased fee, Arbitron sued. The district court granted summary judgment to Tralyn on the grounds that the agreement was unenforceably vague because it contained no basis for determining the amount of the increase in the license fee. The court of appeals reversed the summary judgment. The contract was not too indefinite because it allowed Arbitron to determine the increase, which it must do in good faith. (On remand, the district court found that Arbitron had acted in good faith in determining the fee increase. 526 F. Supp. 2d 441 (S.D.N.Y. 2007), *aff'd* 328 Fed. Appx. 755 (2d Cir. 2009).)

§10.6 PRELIMINARY AGREEMENTS

§10.6.1 The Categorization of Preliminary Agreements

In many transactions, particularly in complex ones, the parties may negotiate at length as they move in the direction of making an agreement. It is not uncommon for parties to record preliminary understandings and agreements during the course of their negotiations and before they reach the stage of making a final and comprehensive contract. Common terms used by parties to label such preliminary agreements are "memorandum of understanding" (sometimes abbreviated as MOU) or "letter of intent" (sometimes abbreviated as LOI). For example, the owner of property in the central city, currently used as a parking lot, wishes to develop it into a mixed-use complex consisting of offices, apartments, and shops. He begins discussions with a construction contractor with a view to forming a joint venture to accomplish this development. Before construction can begin, the parties must develop plans, seek financing, obtain permits, and try to attract anchor tenants, all of which will take time. It could be years before this complex project is realized. In such a project, it is often not possible for parties to reach a comprehensive and final contract at an early stage because there are too many contingencies and uncertainties that must be resolved. They may therefore first enter into a

preliminary agreement, set out in a memorandum of understanding or letter of intent, in which they set out the framework of their relationship and express the intention of working together to reach the final goal of completing the development of the property. As the project proceeds, further issues will be negotiated and as they are settled the parties might record them in successive preliminary agreements. A final and definitive agreement may not be executed until months or even years after the parties first embarked on the project.

Sometimes the parties make clear the legal effect of these preliminary agreements by specifying whether they are intended to be informal, nonbinding expressions of intent or binding contracts. If the parties clearly and unambiguously state that the preliminary agreement is not yet a binding contract and imposes no legal obligations on them, this resolves the question of its legal effect. However, if they do not do this, there may later be a dispute over the legal effect of the preliminary agreement that will have to be resolved by a court through the process of interpretation. In *Teachers Ins. & Annuity Assn. v. Tribune Co.*, 670 F. Supp. 491 (S.D.N.Y. 1987), the court formulated a categorization of preliminary agreements that has been widely used by later courts. It identified three types of preliminary agreements: A "Type I" preliminary agreement is a binding contract. Although preliminary in form, it does reflect agreement on all the major issues that need negotiation and the parties' intent to be bound by it. Even though they contemplate executing a final memorandum of agreement, they regard that step as a formality. A "Type II" preliminary agreement settles some terms of the relationship but leaves other important aspects of it to future negotiation. It therefore cannot be a final and comprehensive contract that binds the parties to their ultimate objective. However, it does commit them to continue to work with each other and to negotiate in good faith in an effort to reach a final agreement. A "Type III" preliminary agreement is merely an expression of the parties' intent to work together in the hope of being able to conclude a contract, but they do not intend it to create any binding obligation.

§10.6.2 Nonbinding Preliminary Agreements

It is easiest to deal first with Type III preliminary agreements because the usual assumption is that a preliminary agreement is most likely to fit into this category—it is no more than a tentative record of what the parties have

agreed so far and it creates no obligation on them. It merely records their desire to work together in an effort to reach agreement and enter into a contract. Until that happens, neither party has any obligation to the other and can terminate negotiations at any time. For example, in *Cochran v. Norkunas*, 919 A.2d 700 (Md. 2007), the court examined the language and context of a letter of intent to sell real property and found that the parties did not intend to be bound until they had executed a formal contract. In *Janky v. Batistatos*, 559 F. Supp. 2d 923 (N.D. Ind. 2008), the parties had engaged in an e-mail exchange during the course of trying to settle protracted litigation. One of them claimed that the e-mails constituted a binding settlement agreement, but the court held that they did not. It found the e-mails to be merely an "agreement to agree" because the parties contemplated the execution of a formal agreement, and the e-mails did not fully and clearly resolve all the terms that would have to be addressed in the formal contract.

§10.6.3 Preliminary Agreements That Bind the Parties to Their Ultimate Objective, so That the Final Memorandum of Agreement Is a Formality

A Type I preliminary agreement is preliminary in form, but despite this form, it is clear that the parties intended to be bound by it. It is in fact a completed contract that does bind the parties to their ultimate objective. Even though it might contemplate that a final and comprehensive memorandum of agreement is still to be executed, the parties intend this to be a formality, rather than a prerequisite to contractual commitment. The crucial quality of a binding Type I agreement, which distinguishes it from a nonbinding "agreement to agree," is that it must reflect agreement on all the material terms of the contract. It cannot qualify as a binding commitment to the final objective if there are still important terms to be settled.

§10.6.4 Preliminary Agreements That Bind the Parties to Negotiate in Good Faith

We see in the discussion of an "agreement to agree" in sections 10.5.3 and 10.6.2 that where parties have not yet resolved a material term of their agreement, the most appropriate conclusion is that they have not yet made a contract. However, even if they have not yet reached final agreement and formed a contract, it is possible that they have made a Type II preliminary

agreement that commits them to continue negotiating in good faith to attempt to resolve the outstanding terms.[18] It is possible that the parties expressly agreed to continue negotiation in good faith, which makes it easier to conclude that they did intend to bind themselves to do that. However, in many cases, this intent is not clear and must be implied from the circumstances of the transaction. Courts are wary of implying an obligation to bargain in good faith because parties who are negotiating usually do not intend to make any promises unless and until they reach final agreement and make a contract. Up to that final stage when the bargain is struck, the usual expectation is that either party can break off negotiations at will for any reason. Neither has any duty to persist in negotiations or to pursue consensus. Both are free to lose interest, make unreasonable demands, or refuse reasonable offers. The only sanction for uncooperative behavior is the possible loss of the deal. Therefore, courts usually interpret a letter of intent or memorandum of understanding as nothing more than a nonbinding expression of intent to work toward a contract. *See*, for example, *Burbach Broadcasting Co. of Delaware v. Elkins Radio Corp.*, 278 F.3d 401 (4th Cir. 2002).

However, it does sometimes happen that the facts are strong enough to imply an obligation to continue good faith negotiations. If so, a court may find that the parties entered into a preliminary contract, subsidiary to the hoped-for final contract, in which each gave consideration by forbearing to exercise the right to terminate negotiations at will and promising to negotiate in good faith in an effort to reach agreement on the principal contract.

This was the conclusion reached in *Brown v. Cara*, 420 F.3d 148 (2d Cir. 2005). The owner of a parking lot in Brooklyn and a construction contractor decided to embark on the development of the lot for commercial and residential use. They entered into a memorandum of understanding in which they agreed to work together to "develop, build, market, and manage a new real estate venture planned for" the site. The memorandum of understanding recorded negotiations up to that stage, set out a general framework for the project, allocated responsibility for various tasks that had to be completed, and stated the parties' intent to enter into a formal contract later. One of the first tasks was to apply for rezoning of the property. This task was allocated to the contractor, which completed it successfully, spending considerable effort and resources in drafting preliminary designs, attending public meetings, and lobbying officials. However, negotiations did

not proceed smoothly after this, and the owner eventually terminated the collaboration. The contractor sued the owner to enforce the memorandum of understanding. The court held that the parties had not entered into a Type I preliminary agreement. The memorandum of understanding did not bind the parties to the ultimate objective of completing the project because it had not settled all matters that needed to be resolved in the future and it contemplated further negotiations before a final comprehensive agreement could be executed. However, the court found that the memorandum of understanding was a Type II preliminary agreement that bound the parties to continue to negotiate in good faith in an attempt to reach final agreement. The factors that most influenced the court in reaching this conclusion were that the memorandum of understanding had expressed the parties' agreement to work together toward their ultimate goal; the project was complex and was subject to many contingencies that made it impossible to settle all the terms in advance, so the parties needed to commit to a general framework in advance while leaving details open for later resolution; and the contractor had already made an extensive and valuable contribution to the project by obtaining the rezoning.

As noted at the beginning of this section, it is easier to find a Type II preliminary agreement if the agreement expresses the parties' intent to commit to good faith negotiations. In *Brown* the fact that the memorandum of understanding suggested this was an important factor in finding it to be a Type II agreement. However, sometimes the parties create a confusing situation by including contradictory indications of intent in the preliminary agreement. In *Gas Natural, Inc. v. Iberdrola, S.A.*, 33 F. Supp. 3d 373 (S.D.N.Y. 2014), the parties' letter of intent stated expressly that it was nonbinding and that no obligation would arise until a definitive agreement has been executed. However, elsewhere in the letter it stated that the parties would engage in good faith negotiations over a stated period of time. The court found that the stated obligation to negotiate in good faith weighed more strongly than and qualified the statement that the letter did not create a binding obligation, making the letter a Type II preliminary agreement.

It is one thing to recognize a duty to negotiate in good faith, but quite another to determine, once negotiations have broken down, what conduct constitutes a lack of good faith and whether the failure of agreement is attributable to a breach of the duty. In some situations, it is easy to see that a party made no good faith attempt to negotiate. For example, in *Brown* the

owner of the lot terminated negotiations and made no pretense of trying to work through the unresolved issues. Lack of good faith may also be clear where a party does not abandon negotiations, but behaves obstructively, for example, by raising new objections to settled terms or remaining inexplicably obstinate. Bad faith is much harder to establish if the party goes through the motions of negotiations with the ulterior resolve not to reach agreement.

In *Apothekernes Laboratorium for Specialpraeparater v. IMC Chemical Group, Inc.*, 873 F.2d 155 (7th Cir. 1989),[19] the court provided some guidance on the general standard imposed by the duty to negotiate in good faith. It said that a party is not required to abandon its interests or to make undesired concessions. Rather the standard contemplates that the party makes a genuine and sincere effort to build on what has been settled and to attempt to resolve differences. In *Gas Natural*, after deciding that the letter of intent did bind the parties to negotiate in good faith, the court had to decide whether the defendant had breached the obligation of good faith by conducting negotiations with another party at the same time, and not telling the plaintiff that it was doing so. The court held that self-interested conduct is not in itself bad faith. Bad faith requires some form of deliberate conduct that is dishonest or aimed at backing out of the commitment. In the absence of a provision committing the defendant to negotiate exclusively with the plaintiff, it was not bad faith for the defendant to simultaneously negotiate with another party in the hope of getting a better deal.

Even if a breach of faith can be proved, the victim may have trouble showing the fact and extent of loss. The breach of a contract to bargain in good faith would theoretically give rise to a claim for expectation damages—a monetary award designed to place the plaintiff in the economic position he would have been in had the other party not breached. The problem is that the plaintiff must prove those damages with reasonable certainty, and this is a difficult burden with regard to a contract to bargain in good faith. This is because a promise to negotiate in good faith is not a promise that agreement will be reached but merely a commitment to make honest efforts to reach agreement. The plaintiff therefore has no guarantee and will find it difficult to show with reasonable certainty that good faith negotiations would have led to a contract. Even if he can prove that, he may find it difficult to show what the ultimate contract terms would have been or what gain he would have made from the contract. As a result, in many cases, the plaintiff cannot recover expectation damages because his alleged loss caused by the breach of the

duty is too speculative. However, where a party to a contract cannot prove expectation damages, reliance damages are available as an alternative. (This is discussed in sections 18.7 and 18.8.) As in the case of promissory estoppel, reliance damages for breach of contract reimburse losses and expenses incurred in reliance on the promise. The effect of this is that damages for the breach of a contract to negotiate in good faith usually turn out to be the same as promissory estoppel damages for reliance on a promise to bargain in good faith, discussed in section 8.9.

§10.7 MISUNDERSTANDING: TOTAL AMBIGUITY

As discussed in section 10.1, interpretation is based on the objective meaning of the language of an agreement, viewed in its context. We seek to ascertain not what each party thought or believed but what they reasonably appeared to intend. Therefore, when the parties have different understandings of their agreement, the party with the more reasonable understanding prevails.

However, it sometimes happens that while the parties have diametrically opposite understandings of a term, each of their interpretations is entirely reasonable, and there is no basis for preferring one over the other. In such cases, interpretation and construction cannot resolve the uncertainty in the apparent agreement. If the uncertainty relates to a material aspect of the agreement, the only conclusion to be reached is that no contract came into being.

Cases involving this kind of irresoluble clash of reasonable interpretations are rare. One of the few cases involving such a situation is the classic mid-nineteenth-century English case, *Raffles v. Wichelhaus*, 159 Eng. Rep. 375 (Ex. 1864). A buyer and seller agreed to the sale of cotton on board the ship *Peerless* sailing from Bombay. It so happened that there were two ships named *Peerless* due to leave Bombay with a cargo of cotton in October and December, respectively. The seller had the later ship in mind and the buyer the earlier. Neither of them knew of the existence of the second ship. The ship contemplated by the buyer arrived in England first, but the seller did not tender delivery from that ship. In fact, he apparently did not even own that cotton. When the second ship arrived and the seller tendered delivery, the buyer refused to accept the goods, contending that he had bought the cotton

on the earlier ship. The seller sued for breach of contract, but the court granted judgment in favor of the buyer on the ground that the misunderstanding prevented a contract from arising.

The doctrinal basis of the opinion is obscure, so it can be (and has been) interpreted simply as an outmoded subjectivist case, in which the court refused to find a contract in the absence of an actual meeting of the parties' minds. However, the case is now widely accepted as illustrating the kind of situation in which even an objective approach cannot resolve the misunderstanding. As each party was reasonable in believing that the agreement referred to a particular ship, and neither had any reason to know of the other's contrary understanding, there is no way to decide whose meaning should be preferred. That is, there is no objective criterion for deciding which ship must have been intended, and a contract on reasonable terms cannot be established. Hence, assuming that the date of delivery is a material term, no contract came into being.

Restatement, Second, §§20 and 201 seek to convey this principle in language so convoluted that it boggles the mind. In essence, the Restatement's rule boils down to this: A material misunderstanding precludes contract formation when the parties were equally innocent in not reasonably realizing the misunderstanding or equally guilty in realizing it but saying nothing. However, if on balancing the degree of fault of the parties, it appears that one is more accountable than the other for knowing of the misunderstanding, a contract must be found to exist on the terms understood by the more innocent party.

The *Peerless* principle may be illustrated by a more modern case involving computer accessories rather than ships sailing from Bombay. In *Konic International Corp. v. Spokane Computer Services, Inc.*, 708 P.2d 932 (Idaho 1985), a Spokane employee was instructed to investigate the purchase of a surge suppressor. After making inquiries of several sellers, in which he was quoted prices ranging from $50 to $200, he had a telephone conversation with a Konic representative, who had a product suitable for the purpose. When asked the price of the suppressor, the Konic salesman said, "Fifty-six twenty," by which he meant $5,620. However, the Spokane employee, having been used to hearing prices in the $50 to $200 range, assumed he meant $56.20. The suppressor was ordered and installed before this misunderstanding was discovered. Upon realizing what had happened, Spokane tried to return the suppressor, but Konic refused to take it back.

Applying *Peerless* and Restatement, Second, §20, the court held that no contract had been concluded because there had been a complete failure of communication. Each party attached a materially different but reasonable meaning to the manifestation, and neither knew or had reason to know the meaning attached by the other.

§10.8 A TRANSNATIONAL PERSPECTIVE ON INTERPRETATION

Both the UNIDROIT Principles and the CISG approach interpretation as a broad inquiry into the language and overall context of the transaction for the purpose of most accurately determining the parties' intent. Article 4.3 of the UNIDROIT Principles identifies as relevant to interpretation the parties' negotiations, their prior dealings, their conduct subsequent to contracting, and usages. Articles 8 and 9 of the CISG are to similar effect.

The CISG requires a contract to be definite, but several articles (for example, Articles 31 and 32) provide gap fillers that may be used in the absence of specific agreement on various terms. Article 55 recognizes that a reasonable price can be supplied in the absence of a stated price. The UNIDROIT Principles also include gap fillers (for example, in Articles 5.1.6 on quality of performance and 5.1.7 on price). Article 2.1.4 adopts a flexible approach to indefinite terms. It allows the court to settle indefinite terms on a reasonable basis unless it is clear that the parties did not intend a contract until they resolve the indefinite term. Article 2.1.15 of the UNIDROIT Principles generally recognizes that parties are not bound until negotiations are complete, but it does impose liability on a party who negotiates in bad faith.

Examples

1. Claire Cutter decided to remove a large oak tree in her front yard. She hired Jack Lumber, a tree remover, to cut it down. Jack has no liability insurance, so he requires his customers to sign a simple one-page written contract that includes the following standard term, drafted by his attorney: "By signing this contract, the customer assumes sole responsibility for any loss, damage, or injury caused by the performance

of work under this contract and indemnifies Jack Lumber for any such claims."

Claire read and signed the contract. Jack began work a few days later. He negligently failed to take proper precautions to ensure that the tree would fall safely. As a result, it crashed down onto Claire's driveway, pulverizing Jack's truck that was parked there. Jack says that the indemnity clause in the contract makes Claire liable to him for the cost of replacing his truck. Is he right?

2. Fairest Fowls, Inc., is a poultry supplier. Gordon Bleu is a trained chef who owns and operates a restaurant. Gordon had often ordered duck and chicken from Fairest Fowls before. Although he had always ordered the cheaper quality "regular" birds, rather than the more expensive "gourmet" quality, he had always been well satisfied.

   Gordon decided to begin serving more exotic game birds at his restaurant. He found a recipe for pheasant and checked Fairest Fowls' price list to see what it cost. The list showed "regular" pheasant for $5.00 per pound, and "plump deluxe" pheasant for $12.50 per pound. Gordon ordered and received 50 pounds of the "regular" quality.[20] He prepared the birds according to his recipe. When they were cooked, he tasted them and discovered that they were tough and uneatable. He called Fairest Fowls to complain. Fairest Fowls' representative expressed surprise that Gordon did not know what was "common knowledge" in the trade—that "regular" pheasants were old, scrawny birds, sold only for making soup. The more expensive "plump deluxe" variety were intended for eating.

   After being told this, Gordon asked some other chefs and wholesale poultry suppliers (eight people in all) if they knew about the distinction between "regular" and "plump deluxe" pheasants. Five of them were fully aware of it and used the same terminology in their businesses. Two did not know the terminology, but they knew that you could not buy eatable pheasant for $5.00 per pound. One had never heard the terminology and would have assumed that you could eat regular pheasant.

   In light of this, did Fairest Fowls breach the contract by delivering uneatable birds to Gordon?

3. Beau Teek operates a clothing store in a shopping mall under a five-year

lease. One of the terms of the lease gives Beau the option to renew the lease for a further period of five years "at a rental to be agreed at the time of renewal in light of the prevailing economic conditions."

Beau properly exercised his option to renew within the time specified in the lease. Although the parties tried to agree on rent for the renewal period, they were unable to reach consensus. The lessor called on Beau to vacate the premises, but he refused to leave and commenced suit for specific performance, requesting that the court order the lessor to extend the lease for a five-year period at a rent determined by the court to be reasonable. Should the court grant the order and determine a reasonable rent?

4. Jill Loppy agreed to sell her old car to Carr Less. They wrote out the following on a piece of paper and both signed it: "Jill Loppy agrees to sell her 2001 Chev to Carr Less for 90 percent of its retail Bluebook value."

   The next day, Jill changed her mind and no longer wished to sell her car. She claims that she does not have a binding contract with Carr and points out that the piece of writing is too skimpy to be a contract because it does not fully describe the car, has an indefinite price term, and omits many essential terms. In particular, it makes no mention of the delivery and payment obligations and does not say if the car is sold with or without any warranty. Furthermore, these issues were not discussed by the parties. Is this a good argument?

5. Chic, Lady Lingerie, is a budding fashion designer. She entered into an agreement with Deadwood Design Agency, a fashion design agent, under which Chic granted Deadwood the exclusive right for two years to sell her fashion designs. In consideration, Deadwood promised to pay Chic half of all profits and revenues that it earned from any such sales. Chic delivered her extensive portfolio of designs to Deadwood.

   Hearing nothing from Deadwood for a month, Chic called to find out how sales were going. Deadwood told her that sales were slow, but she should be patient because things would pick up soon. After waiting another month, Chic received a check for $300 from Deadwood, her 50 percent share of earnings for the sale of two designs for small garments. In a note accompanying the check, Deadwood apologized for the small return, saying that it hoped to do better in the future.

About two weeks later Chic ran into one of her classmates from design school. The classmate told Chic that he had been approaching manufacturers directly and had sold over $2,000 worth of designs in the last six weeks. Chic would like to dump Deadwood. Can she do so without breaching the contract?

6. Woody Cutter, a lumberman, owned a sawmill. His business was failing, and he had accumulated debts of $1.5 million. He decided to sell the sawmill, which was appraised at $3.5 million. Empire Building Products Co. wished to buy a sawmill. It heard that Woody's mill was on the market, so it approached him to negotiate a sale. After several weeks of meetings, involving attorneys, accountants, and technical advisors, the parties had reached agreement on all the terms of the sale except price. They were deadlocked on this issue. Empire had refused to pay more than $2.5 million. However, Woody refused to take less than $4 million for it. The parties therefore felt that a cooling-off period would be useful, and they agreed to meet two weeks later to see if they could resolve their differences on price. They signed a joint memorandum drafted by their attorneys, setting out the terms on which they agreed so far, and recording simply that they would meet on a stated day to continue discussions on price.

   Empire's board met just before negotiations were to resume. Realizing that Woody was under pressure to sell and that he had no other prospective buyer, the board decided not to budge on the $2.5 million price. They knew that this would be a bargain because of the $3.5 million appraised value of the mill. At about this same time, Woody, reviewing his precarious financial position, decided not to hold out for his asking price but to come down as low as $3.2 million (which he realized was below the mill's true value).

   When the meeting took place as arranged, Woody made great efforts to persuade Empire to close the gap between the price proposals, but Empire refused to consider anything above $2.5 million. As a result, the negotiations terminated in failure. Unable to sell his sawmill, Woody could not pay his debts. His creditors seized his sawmill in execution and sold at auction. Because prices at such execution sales are depressed, the sawmill sold for $1.5 million. Woody claims that had Empire negotiated with him in good faith, they would have reached agreement on the sale of the sawmill for $3.2 million, which would have

been enough to pay his creditors with a significant surplus over for him. Woody has sued Empire for $1.7 million, the difference between $3.2 million and the execution sale price of $1.5 million. Is he entitled to those damages?

7. Molly Fido owned a profitable and successful restaurant. She decided to sell the business and she solicited inquiries by placing an advertisement in a trade journal. Faith Fullness responded and they met to discuss the possible sale. At their initial meeting, Faith examined the premises, equipment, and financial records and the parties had extensive but inconclusive discussions about price. Faith expressed strong interest in buying the business and they agreed to meet again in a week. During that week, Faith visited the restaurant several times to observe the operations, service, and customer traffic. She visited her bank to discuss financing and spoke to a couple of potential investors to see if she could raise some capital. Everything looked promising, and she became enthusiastic about buying the business.

   At their next meeting, Faith and Molly discussed the sale in earnest. After some hours they had reached agreement in principle on the basic terms of the sale, which Faith wrote down on a yellow legal paid: Faith would pay Molly $750,000 for the equipment, name, goodwill, lease rights, and transferrable licenses. A third of the price would be paid upon the signing of a written agreement, and the balance would be paid in installments over two years. Faith would take over the business and receive transfer of its assets as soon as possible after the agreement was signed, and Molly would remain on as an employee of the business for six months at a salary to be mutually decided. Faith would immediately instruct her attorney to draw a written contract reflecting these terms and dealing with any necessary matters of detail that the parties had not thought of. Later that day, Faith consulted her attorney and gave her the pad with the notes of the meeting. The attorney promised to set to work as soon as possible on drafting the memorandum of agreement.

   The next day, Molly received a call from Ruth Less who had also read the advertisement. Molly told Ruth that she had almost certainly sold the business already, but agreed to meet with Ruth anyhow. After a whole day’s negotiations, during which Molly disclosed to Ruth the terms of the understanding with Faith, Ruth made a very attractive offer. She is willing to buy the business for $900,000 cash. Molly would like

to accept the offer but is unsure if she has legally committed herself to Faith. Has she?

8. Pierre Less saw the following homemade poster on a lamppost near his home: “Lost Dog—Reward $100. If anyone sees a black poodle with the name tag “Raffles” on his collar, please bring him to 1864 Bombay St. to receive this reward.” The next day Pierre came across a black poodle which was scurrying about the neighborhood in a state of distress. He looked at the poodle’s collar and saw that he had a name tag showing his name as “Raffles.” Pierre took Raffles to the address on the poster but the owner would not accept the dog, claiming that it was not his Raffles. It turned out, by strange coincidence unknown to both parties, that another black poodle named Raffles had wandered from his home and had become lost in the neighborhood. The poodle that Pierre found was the wrong one. Nevertheless, Pierre feels that he went to a lot of trouble on the faith of the poster and he wants his reward. Is he entitled to it?

Explanations

1. The question here is whether the indemnity clause is broad enough to impose liability on Claire for loss suffered by Jack as a result of damage he negligently inflicted on his own property in the course of his performance. Do not be too quick to scoff at Jack’s claim—remember that he is handy with a chainsaw.

   This Example invokes *Pacific Gas and Electric Co.* (discussed in section 10.5.1), in which the court held that extrinsic evidence must be admitted to decide whether an indemnity provision in a repair contract covered damage to machinery belonging to the owner or applied only to claims of third parties. In Jack’s case, there is no similar concern about admitting extrinsic evidence of meaning because neither party offers any such evidence. Where there is no contextual evidence that bears on the meaning of contractual language, the court is necessarily confined to finding meaning within the four corners of the document.

   The argument could be made that the language used in this contract is wide enough to cover damage to Jack’s truck. It places on Claire “sole responsibility for…damage…caused by the performance of work under this contract.” This may suggest that she is responsible for any damage that may occur during the course of performance, whatever its kind, and

whoever its victim may be. However, this interpretation is overborne by other indications of reasonable intent in the contract.

The words "indemnifies…Jack…for any such claims" suggest that the contract contemplates that Claire is responsible only to protect Jack from third-party claims. This meaning makes sense in light of the purpose of the clause: work is being done on Claire's property, and she therefore assumes responsibility for any loss suffered by a third party as a result of the work. The trial court in *Pacific Gas* did make the point that "indemnifies" is capable of a broader meaning. However, that case was concerned with damage to the owner's property, not the repairer's. Even if the language can be taken to extend beyond third-party liability, it surely cannot mean that Claire should be responsible for damage caused by Jack to his own property as a result of his own negligence. Such an interpretation seems absurd, and it is most unlikely that Claire reasonably expected a generally worded indemnity provision to impose liability on her for Jack's self-inflicted injury.

In addition to being beyond Claire's reasonable expectations, such a provision is not in the public interest. Courts usually require a very specific disclaimer of liability to exclude damage caused by a party's negligence. (*See* Example 6 of Chapter 13.) A fortiori, a generally worded provision like this cannot give Jack the right to seek compensation from Claire for damage caused by his own negligence. Recall that one of the canons of interpretation is that where the meaning of language is in doubt, a court should choose an interpretation that is reasonable and in accord with public policy.

Finally, if doubt still remains over the proper interpretation of the clause, the *contra proferentum* rule may be used to resolve the doubt against Jack, who is the proponent of the indemnity.

2. This is a sale of goods under UCC Article 2, but interpretation of the agreement is based on principles not significantly different from those applied in modern common law. UCC §1.303 recognizes the primacy of express terms but also articulates the importance of trade usage and course of dealing in the ascertainment of meaning.

   This Example is loosely based on the famous chicken case, *Frigaliment Importing*, discussed in section 10.1.3. The principles set out in that case are helpful in resolving this dispute. The ordinary meaning of language is the point of departure, but "regular" has many

meanings. Possibly Gordon's prior dealings would support his interpretation that a "regular" bird is eatable, but the prior contracts are not very helpful as a course of dealing because they involved different birds and distinguished "regular" quality from "gourmet," not "plump deluxe." We therefore need to go beyond the bare surface meaning of "regular" to ascribe a meaning to the word. The entire context in which it was used indicates that Fairest Fowls's meaning should prevail.

Sometimes other terms in a contract can cast light on the meaning of the term in dispute, so courts interpret language in the context of the agreement as a whole. For example, in *Frigaliment Importing*, the contract's price term was of some help in supporting the seller's argument that "chicken" was used generically, rather than more narrowly to refer only to fryers. It reflected a different price per pound for the larger and smaller chickens, and the price of the larger chickens was below the market price of fryers. We are not told of any terms in this contract that could explain what the parties meant by "regular," but price could similarly be a helpful indicator of intent.

More significantly, our preliminary information on trade usage strongly supports the meaning claimed by Fairest Fowls. (Of course, if the dispute goes to litigation, trade usage would have to be established by sworn expert testimony, but Gordon's informal survey is good enough for present purposes.) Gordon asked chefs and suppliers what they understood "regular" pheasants to mean. Although they were not unanimous in their response, there seems to be widespread recognition in the trade (defined here as the wholesale poultry market) that the word "regular" refers to pheasants that can be used only to make soup. To prove a trade usage, a party needs only establish it on the preponderance of the evidence. A severe clash of the experts could result in failure to discharge this burden, but there does not need to be unanimity to make a credible showing. As a professional chef who buys poultry from suppliers, Gordon is surely a member of this trade. Even if he did not actually know what "regular" meant, he had reason to know the usage and is bound by it.

3. The term relating to the rental for the renewal period is unquestionably vague. It suggests an "agreement to agree," but it does seek to limit the parties' discretion in negotiating by stating a standard: the economic conditions prevailing at the time of renewal. Although the rent provision

in this lease is not as tortured and nonsensical as the one in *Walker v. Keith* described in section 10.5, it may not be any more workable, and a court may refuse to give effect to the renewal agreement. However, there is a plausible argument for upholding it. After all, the rental provision was not simply an "agreement to agree," and it does refer to what could be seen as a market-based standard, albeit poorly expressed. It is not a great leap beyond their expressed intent for a court to determine and apply a reasonable market standard if they cannot reach agreement. In so doing it upholds an apparent serious intent to be bound and conforms to the rule of interpretation that favors an effective meaning over one that renders the term ineffective.

4. Jill does not make a good argument. This is a sale of goods, and the UCC is very clear on the question of omitted terms. Section 2.204(3) states that a contract for sale does not fail for indefiniteness, even though terms are left open, provided that the parties intended to make a contract and there is a reasonably certain basis for giving a remedy. In addition, Article 2 contains a number of gap fillers that apply to any agreement for the sale of goods in the absence of contrary provisions expressed by the parties. As a result, this skimpy-looking contract is much fuller than Jill suggests.

   The goods sold need not be fully described in the writing. Because Jill owned only one 2001 Chev, the identity of the car is not uncertain, and it can be established by oral testimony. The parties need not fix a specific price, as long as they have indicated an objective market standard or some other reasonably certain means of determining it. This agreement expresses a workable market standard. (Even had it not done so, UCC §2.305 provides the gap filler of a reasonable price unless it is apparent that the parties did not intend to contract for a reasonable price.) If any of the remaining terms had been settled orally by the parties and just not stated in the writing, oral evidence of their actual agreement would establish these terms. In the absence of any such agreement (and any applicable usage and course of dealing or performance), the UCC provides the following supplementary terms:
   a. The seller is obliged to transfer and deliver the goods, and the buyer must accept and pay for them (§2.301).
   b. The seller accomplishes her tender of delivery by holding the car available for collection by the buyer at her home at a reasonable hour

and for a reasonable period (§§2.308 and 2.503). In addition, because the state requires registration of transfer of title for motor vehicles, the certificate of title must be tendered with proper endorsement.

c. The delivery must take place within a reasonable time (§2.309).
d. The buyer must pay for the goods (in cash) on receiving them (§2.310).
e. The seller warrants that she has good title to the goods (§2.312). (A full discussion of UCC warranties is beyond our scope. It is enough to note that no other warranties are implied in law. The two other implied warranties, set out in §§2.314 and 2.315, are not applicable on the facts of this case.)

5. As you may have suspected, this is a cleverly disguised ripoff of *Wood v. Lucy, Lady Duff-Gordon*, discussed in sections 10.1.1 and 10.2.2. As in *Wood*, we can easily infer from the underlying commercial purpose of the contract that Deadwood impliedly promised to make best efforts to place Chic's designs. However, this is a harder case because it requires us to give content to the obligation to use best efforts. The court did not have to do that in *Wood* because it was not Wood's duty to Lucy that had to be enforced but Lucy's duty to Wood. (She had sold designs herself in violation of the agreement, and Wood sued her for his share of the profits.) Because the court needed to imply the obligation of best efforts only for the purpose of finding that Wood gave consideration for Lucy's promise, it did not have to decide what would have constituted best efforts. Since Chic asserts that Deadwood has fallen short of best efforts, we need to tackle the question of what level of effort would satisfy Deadwood's obligation.

   To decide what constitutes best efforts, we must examine both the reasonable expectation in the trade and the scope and resources of Deadwood's operation. The standard seems to be a blend of reasonable efforts (evaluated objectively) and honest efforts (measured subjectively). We do not have enough information to make a decision on whether Deadwood's efforts would qualify. Deadwood apparently had very little success, and Chic's classmate did better without representation. But that, on its own, is not enough to prove that Deadwood breached its obligation of best efforts. The test is not one of result but of endeavor.

6. The parties clearly did not have a final contract at the end of their first set of negotiations. The price term was unresolved and there is no indication that they intended to be bound unless it was settled. This is not a case in which it would be justifiable to infer that they agreed to a sale at a reasonable or market price.

   Therefore, the only basis of liability is that the parties had entered into a Type II preliminary agreement that bound Empire to continue negotiating in good faith and that it breached it by standing firm and refusing to negotiate further on the price. Negotiations are normally precursors to legal commitment, and they do not in themselves usually give rise to any legal obligations. In most cases, until the parties actually reach agreement and conclude a contract, neither assumes the legal duty to keep negotiating or to try to reach consensus. This has to be the general rule otherwise it would become difficult to distinguish negotiation from agreement, and entering into negotiations would carry too high a risk of liability. As stated in section 10.6, courts are concerned about hampering negotiations by imposing a duty of good faith negotiation and are cautious about implying such an obligation except in the most compelling cases.

   In this case, the parties had proceeded quite far in their negotiations and had agreed to meet further to try to resolve their differences over the purchase price. Empire knew that Woody was in trouble, he needed to sell, and his options for preserving his business were running out as time passed. It deliberately used his distress to obtain bargaining leverage. A great deal of energy had gone into negotiations already, and substantial consensus had been reached. Given Empire's apparent interest in the transaction and its willingness to meet again, these facts could support the conclusion Empire had the duty to return to the bargaining table in a spirit of honest compromise. However, this is not an easy case to make because Woody has to overcome the usual presumption, in the absence of an express commitment, that the parties do not intend to make binding commitments in negotiations. To overturn the presumption, the relationship between the parties must be close enough, and the contributions made to the transaction by the one or both parties are substantial enough that the parties can reasonably be seen to have assumed an extraordinary duty of collaboration.

   If an obligation to bargain in good faith is implied in this case, what

must Empire have done to satisfy it? Bad faith is easy to identify in situations where a party simply refuses to negotiate, but it is much more difficult to define in close cases where there is a thin dividing line between bad faith and acceptable commercial hardball. It would not in itself have been bad faith for Empire to make a business decision to stick to its price limit. A party should not be compelled to pay more than it desires. However, when Empire's knowledge of Woody's circumstances and its motive for the refusal to budge are taken into account, its insistence on the low price looks decidedly less wholesome. This is particularly so given Woody's concessions that considerably narrowed the price gap between them.

If Empire did breach its duty to bargain in good faith, what is Woody's remedy? Woody is claiming expectation damages based on the difference between the $3.2 million he wished to get for the property and the $1.5 million execution sale proceeds. The problem with this claim is that it assumes that had Empire bargained in good faith, the parties would eventually have made a contract and that they would have settled on a price of $3.2 million. However, Woody will have trouble in proving that good faith negotiations would have led to a contract and, if they did, what the sale price would have been. Therefore, Woody's chance of recovering expectation damages is poor. At best, he might be able to recover reliance damages based on any cost and expense that he wasted in the course of the negotiation.

7. When parties have agreed in principle to the essential terms of a contract, but they contemplate executing a formal, signed writing, the legal effect of their oral or informal[21] agreement may be unclear if they do not specifically express the intended effect of the oral or informal understanding. They may have intended no commitment whatever until the writing is signed. Conversely, they may have concluded a contract already, subject merely to the formality of writing. As a third possibility, even if they have not yet made a final commitment, they may at least have undertaken to bargain over the unresolved issues in good faith. Their purpose must be determined from all the circumstances of their interaction.

   All the usual avenues should be explored for helpful indications of intent: the language of agreement itself, statements or actions during negotiations, trade usage, and course of dealings or performance. No

facts are given to suggest that there is any specific trade usage, and there is no indication of prior dealing or subsequent performance, so the only source of information is the circumstances of the transaction itself, evaluated in light of usual commercial standards. Comment *c* to Restatement, Second, §27 suggests some of the factors that may help in deciding if a contract was concluded orally or informally. They include considerations such as the extent of the express agreement; the nature and extent of unresolved issues; whether it is normal practice—or, stronger still, legally required—to put a contract of this kind in writing; and the value and complexity of the transaction.

There are some indications that suggest that the parties did not yet intend to be fully bound in contract. The sale of a business is a commercial exchange of a relatively complex and valuable nature, and it seems reasonable to assume that parties would normally expect to sign a written memorandum before being bound. This assumption is strengthened by the fact that a number of known or possible issues were left unresolved. Not only did they deliberately leave open the salary to be paid to Molly for her work in the six months following the sale, but they also anticipated further unidentified issues to emerge when Faith's attorney drafted a comprehensive writing. Some of these may be trivial, but some could be significant and contentious. Of course, these are merely indications. They are not conclusive, and an argument can be made for the opposite result.

It is therefore conceivable that Molly and Faith had entered a binding contract of sale at the conclusion of negotiations. If so, Molly risks legal liability if she reneges. Because this is a close question, let us consider what would happen if there was no final commitment at that stage. Would this mean that there is simply no contract, or do the circumstances suggest that the parties at least agreed to bargain in good faith on unresolved issues, promising to sign unless they encounter a genuine deal breaker? The circumstances are ambiguous and may not be strong enough to deprive Molly of her normal right to abandon these negotiations in favor of a better deal. The facts do not indicate the level of trust, commitment, or reliance discussed in section 10.6 and Example 6. Nevertheless, Faith's dealings with Molly are quite far advanced, oral agreement has been reached on all apparently material terms, and Molly has at least given some implicit assurance that there are no obstacles to

the completion of the transaction. It is therefore possible that a court may find that they had reached a stage that precluded Molly from walking away from the deal.

If this is so, it does not invariably mean that Faith is entitled to relief, because she has to prove economic loss. As stated in Example 6, this means that she will have to prove both that the contract probably would have resulted but for Molly's refusal to proceed further and that following the purchase of the business, she would have been reasonably likely to have made profits in a reasonably certain amount. In the absence of this proof, she may be awarded reliance damages if any reliance loss was suffered. She may have incurred some expenses relating to her inquiries before the second meeting, but these were not incurred in reliance on any promise and are therefore not recoverable. No reliance losses are indicated following the implied promise to bargain in good faith.

8. By placing the poster on the lamppost, Raffles' owner made an offer for a unilateral contract. Pierre accepted it by the act of returning a dog called Raffles to him. (*See* section 4.12.3.) Your initial response to this Example may be that although Pierre intended to accept, he did not in fact do so because return of the wrong dog was not performance of the act required for acceptance. However, the wording of the poster simply offers the reward to anyone who "brings" to the stated address a lost black poodle with the name tag "Raffles" on his collar. Pierre performed that act exactly as specified. Of course, Raffles's owner intended to refer to his own dog, but his subjective intent is not determinative. (Maybe it could be argued that the reasonable implication from the poster is that the offer called for the return of the dog owned by the offeror. This is a plausible argument, but the literal wording of the poster does not say that.)

   However, even if Pierre prevails on the offer and acceptance issue, he is not likely to get his reward. While the objective test holds the owner to the reasonable meaning of his words, it presupposes that it is possible to determine the reasonable meaning of the disputed language. If the parties have different understandings of a word and the court cannot say which of them is more reasonable, the objective test cannot resolve the dispute and the conclusion must be that the agreement is subject to a fatal and irresoluble ambiguity. On the principle of *Raffles v.*

Wichelhaus, as embodied in Restatement, Second, §20 (see section 10.8), there can be no contract, even under the objective test, if the double meaning of the name cannot be settled by recourse to its most reasonable meaning and the parties are equally blameless for the misunderstanding. Maybe Raffles' owner can be faulted for the way that he worded his poster, but can he be held accountable for not anticipating the possibility that there could be two black poodles called Raffles in the area?

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1. For example, section 7.9.2 discusses the implication of a promise to use best efforts or to exercise reasonable judgment as a means of giving content to an apparently illusory promise, and section 4.1 discusses the interpretation of objective manifestations of assent in the context of offer and acceptance. This is not a definitive list. The issue of interpretation comes up often.
2. Where the agreement is recorded in writing, a party's ability to offer evidence of context is much more heavily restricted because of the parol evidence rule, discussed in Chapter 12. In this chapter, we focus on the sources of evidence available to interpret language in the agreement, and are not concerned with the parol evidence rule. In Chapter 12 we examine barriers to admissibility of contextual evidence created by the rule.
3. An oral agreement is legally binding and enforceable unless the statute of frauds, discussed in Chapter 11, requires it to be written (or recorded). However, even if valid, an oral agreement presents problems of proof that are obviated or reduced by recording the agreement. If there is a dispute over the exact language used by the parties in an oral agreement, the actual words used must be proved as a fact before they can be interpreted. Also, where the agreement is written or recorded, the parol evidence rule (*see* Chapter 12) may preclude evidence of alleged oral terms that were not included in the writing or record.
4. Again, if the agreement is written or recorded, the parol evidence rule may restrict the admission of this evidence. *See* Chapter 12.
5. Note that the focus is on presumed knowledge rather than actual knowledge of usage. The effect of this is that usage sometimes enters a contract as a matter of construction, not interpretation. This reinforces the point made in section 10.1.1 that the dividing line between these processes is often blurred.
6. This case is discussed further in relation to the parol evidence rule in section 12.10.
7. *See* section 13.13.3 for a further discussion of the public policy concerns relating to covenants not to compete.
8. There may be a difference between "reasonable efforts," which appears strongly objective, and "best efforts," which suggests some blend of subjective and objective standards. However, the distinction is probably not substantial. Whichever term is used, the decision on what constitutes an acceptable effort should take into account both the objective market standards and the subjective honesty and particular circumstances of the party who is to exert the effort.
9. *See* section 7.9.3 for an explanation of this type of contract.
10. *See* sections 2.7.2 and 6.3.2 for the definition of "merchant."
11. This broad definition of materiality is sufficient for present purposes. Materiality is also discussed in section 6.3.2 in connection with the battle of the forms and is examined in greater detail in section 17.3 in relation to breach of contract.
12. As an alternative to his contract claim, Baer sought relief in restitution, claiming that Chase had been unjustly enriched by Baer's services. The trial court initially dismissed this claim on the ground that the statute of limitations had run. Dismissal on that ground was reversed on appeal, and the trial court ultimately awarded Baer restitutionary damages. However, because the court found the market

value of Baer's services to be modest, the amount of his recovery was small. *Baer v. Chase*, 2007 WL 1237850 (D.N.J. 2007).

13. He also sued Hallmark for tortious interference with contract on the grounds that it induced Angelou's breach by contracting directly with her knowing that Lewis had been negotiating with Hallmark on her behalf.

14. The term "four corners" is also used to describe an approach to the parol evidence rule in which the court determines from the written contract alone whether an alleged parol term should be allowed to supplement the writing. You therefore find this term used again in the discussion of the parol evidence rule in Chapter 12.

15. In the end, the admission of the evidence did not help the author. On remand, the jury heard the expert evidence on usage, but nevertheless concluded that the term covered only cash receipts. *See Wolf v. Walt Disney Pictures and Television*, 76 Cal. Rptr. 3d 585 (Cal. App. 2008).

16. In some circumstances, even though the court finds that deferral of a term precluded contract formation, it may conclude that the parties did make a commitment to continue to bargain in good faith. This possibility is discussed in section 10.6.

17. This case is discussed in the context of clickwrap terms in section 5.3.

18. Section 8.9 discusses the possibility that in a rare case, a court may apply promissory estoppel to compensate a party for reliance on a promise made in negotiations. The underlying premise of the cases discussed in section 8.9 (such as *Hoffman v. Red Owl Stores*, 133 N.W.2d 267 (Wisc. 1965)) was that the promissory estoppel relief was needed to avert injustice because the promisor had violated a duty to bargain in good faith. Therefore, there is some affinity between what is discussed in section 8.9 and the discussion in this section. However, the important difference is that in section 8.9 we deal with a promise (usually implied) by one party and reliance by the other. Here we discuss the possibility that both parties committed to continue good faith negotiations, so there is an express or implied contract to continue negotiations in good faith.

19. If you can say the name of this case ten times while standing on one leg, you are not too drunk to operate a vehicle.

20. The order was oral, but as the total price of the birds was $250, the statute of frauds is not applicable. Also, because there is no written memorial of agreement, the parol evidence rule does not apply to complicate matters. This same contract, in written form, is used in Example 4 of Chapter 12 to illustrate the impact that the parol evidence rule would have on the resolution of this interpretational issue.

21. The term "oral or informal" indicates that the preliminary understanding could either be oral or in some written form short of a final contract. In this Example, the parties' agreement was oral, but it was noted down in an unsigned writing on a yellow pad. As discussed in section 10.7, an agreement in principle could be even more formal, and could be written up as a signed "letter of intent," which memorializes what has been agreed and provides a framework for further negotiation.

The Statute of Frauds

§11.1 INTRODUCTION

As a general rule, the law gives effect to oral contracts. Although it is almost always a good idea to record a contract (whether in a physical writing or in some other retrievable form) to facilitate proof of the fact and terms of agreement, for many contracts this record is not a prerequisite to validity or enforceability. However, certain types of contract fall outside this general rule and must be written or otherwise recorded and signed to be enforceable. The requirement of a written record for specified types of contracts[1] entered the law of England just over 300 years ago, through a statutory enactment during the reign of King Charles II. As originally conceived and as applied until the advent of electronic media, the statute contemplated that writing and signature would be in tangible form on paper. The rapid advance of communications technology has required the adaptation of "writing" and "signature" to take account of communication by other, particularly electronic, media. This change is reflected both in court opinions that recognize the recording and signature of contracts in retrievable electronic form as the legal equivalent of writing and signature on paper, and in state

and federal statutes that make electronic signatures effective. (This is discussed further in section 11.3.) Therefore, unless the context indicates otherwise, assume that the words “written” and “writing” include other means of recording.

The original motivation for the rule was a concern over fraudulent testimony, hence the original name of the statute, “An Act for Prevention of Fraud and Perjuries,” which came to be shortened to “the statute of frauds.” Its principal function was to ensure that a person could not seek to enforce an obligation of the kind covered by the statute purely on the basis of unreliable and possibly perjured oral testimony, but would have to produce some adequate written record of the contract. American jurisdictions have adopted statutes modeled on the original statute of frauds, covering much the same types of contracts. Over the years, many states have enacted additional statutes requiring writing for further types of contracts. (For example, a writing is required for a contract granting a security interest in personal property under Uniform Commercial Code (UCC) Article 9. Often, consumer protection statutes require a written and signed contract for particular sales of goods and services, and may even specify that the writing must set out the terms governing certain aspects of the transaction.) Therefore, although one usually refers to “the statute of frauds” in the singular, there could be a number of statutes in existence in a jurisdiction, each prescribing writing for a different kind of contract. In this discussion, we are concerned only with the general common law statute of frauds relating to contracts and with that prescribed by UCC Article 2.

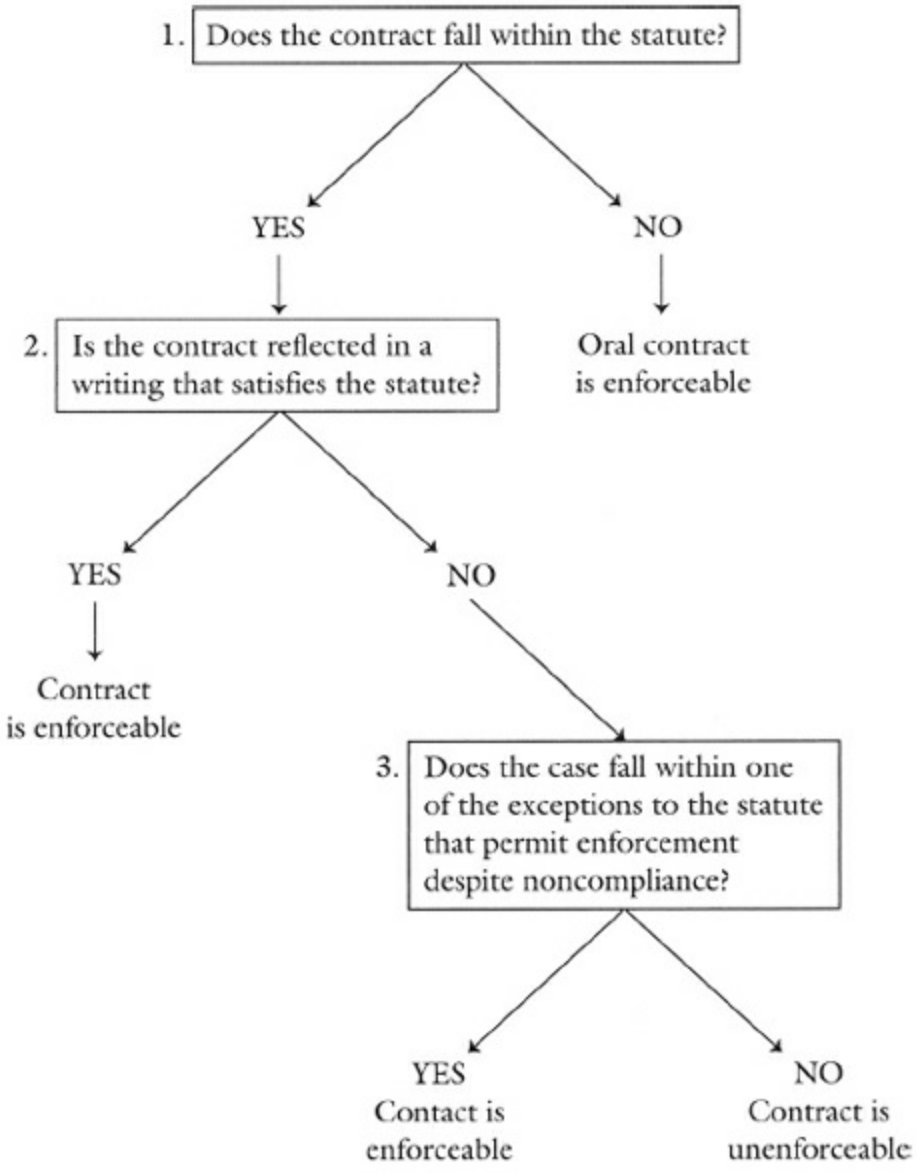
The basic rule of the statute of frauds (referred to from now on as “the statute”) is that a contract within its scope may not be enforced unless a memorandum of it is written and signed by the party to be charged. This gives rise to a few initial observations: First, the statute does not require the entire contract to be written, but only a memorandum of it. The degree to which a writing must set out the detail and content of the contract to qualify as a sufficient memorandum is discussed below. Second, only the party who is to be charged, that is, against whom enforcement is sought, needs to have signed it. The signature of the other party is not needed. The question of what constitutes a signature is discussed below. Third, the consequence of noncompliance is usually unenforceability, not invalidity. This distinction is explained more fully in section 11.5.

The statute is intended to prevent a person from enforcing a falsely

alleged contract through perjured testimony. However, when a contract was really made orally, the statute can equally be used by the party seeking to evade it. For this reason, there is some concern that the benefits of the statute are outweighed by its potential for abuse. It may be better policy to have no requirement of writing and to allow the factfinder to evaluate the credibility of the oral evidence. These considerations led to the repeal of the statute of frauds in England some time ago, but it continues to survive in U.S. jurisdictions. The principal focus of the courts has been on making it more flexible to better ensure that it efficiently achieves its purpose while cutting down on the opportunities for abuse. Sometimes this has been done by legislation (as happened when the statute of frauds relating to sales of goods was given statutory form in UCC §2.201), but more often, reforms develop in the process of judicial application of the original statutory provisions. Restatement, Second, §§110-137 seek to reflect contemporary judicial thinking on the statute.

To determine whether problems of enforcement exist under the statute, it is useful to ask three questions in the order represented in Diagram 11A.

Diagram 11A



§11.2 THE FIRST INQUIRY: IS THE CONTRACT OF A TYPE THAT FALLS WITHIN THE STATUTE?

The original statute covered six types of contract. Although others have been added in different jurisdictions, these six largely continue to make up the core of modern versions of the statute. This shows remarkable durability, since the types of contract covered by the statute are more reflective of the commercial

priorities of seventeenth-century Englishmen than of today's economy. The following subsections of this section describe the six categories of contracts that were included in the original statute and continue to be subject to the statute of frauds. (The categories are listed in Restatement, Second, §110 and expanded on in subsequent sections.) The first three—contracts for the sale of land or an interest in land, contracts that cannot be performed in a year, and sales of goods—cover more common types of transactions. They are the dominant categories and are more likely to be encountered. The last three—suretyships, executors' contracts to answer for a duty of the decedent, and contracts made upon consideration of marriage—relate to a narrower range of more specialized contracts. Each of the six types of contract is explained below.

§11.2.1 Contracts for the Sale of Land or an Interest in Land

Like many rules derived from older English law, this rule reflects the importance of land as the principal means of wealth in English society at the time. The statute applies not only to a contract to sell land but also to any other contract under which land is disposed of, as well as a transfer of an interest in land short of full ownership, such as the grant or transfer of an easement or mortgage. A lease is also an interest in land. The statute of frauds usually applies to long-term leases, but commonly is not applicable to short-term leases.

§11.2.2 Contracts That Cannot Be Performed Within a Year

Any contract, irrespective of its subject matter, must comply with the statute if it cannot be performed within a year of its execution. Note that the rule is not confined to contracts in which the performance itself will take over a year, but includes any contract—however short the period of performance may be—in which the performance will not be completed within a year of contracting. Therefore, if on July 1, 2016, a customer makes a contract with a popular resort to rent a room for July 3 and 4, 2017, the contract falls within the statute, even though the performance will last only two days.

The idea behind the one-year rule is probably to ensure that longer-term contracts are recorded. In part, this reflects the concern that parties cannot be expected to remember unrecorded terms as time passes, but it could also be

motivated by the expectation that a long-term contract may involve greater economic value. Commentators have pointed out that if the rule is motivated by this goal, it does not achieve it very effectively because the one-year period does not relate to the length of performance but the period between the making of the contract and the end of performance. Therefore, the rule just as much governs a short, inexpensive transaction (such as the hotel booking used in this illustration) as a long, expensive one. Whatever the thinking behind the rule, it is obviously arbitrary and if rigidly applied, could result in absurd distinctions. For example, if an employment contract is entered into on Monday, for a year's employment beginning that day, the statute is not implicated. However, if the employment period is to begin on Tuesday, the statute applies.

Many courts have criticized the arbitrary nature of the rule and have confined its application narrowly, holding that it only applies where the clear terms or nature of the contract prohibit a party from completing performance before the end of the one-year period. That is, it would be a breach for the party to cease performance before the end of the period. For example, on June 1 the owner of a building enters into a one-year contract with a property management company for the management of the building. By its nature, the clear purpose of this contract is that the management company will continue to perform its duties for the entire contract period. It does not contemplate that the management company could accelerate performance of the contract by working extra hard to get done with its management duties before the year is over. By contrast, the owner of a building enters into a contract with a construction contractor under which the contractor commits to complete renovations to the building within 14 months. This contract does not, by its nature, preclude the contractor from working extra hard so that the building is completed within 11 months. Therefore, although the expectation is that the performance will take more than a year to complete, the contract is not one that, by its terms or nature, may not be completed within a year of its execution. Therefore, it should not be subject to the statute.

Many courts do not treat a contract of indefinite duration as falling within the one-year rule if the contract performance could conceivably be completed within a year or the contract could be terminated within a year, say, by a notice of termination. For example, in *Leon v. Kelly,* 618 F. Supp. 2d 1334 (D.N.M. 2008), the court held that the statute of frauds did not apply to a partnership agreement for an indefinite term because the contract was

capable of being completed in a year: Even though the agreement contemplated a long-term business endeavor expected to last for several years, a partner had the right to dissociate from the partnership and dissolve it at any time. In *Browning v. Poirier*, 2015 WL 2458005 (Fla. 2015), the parties were in a romantic relationship. In 1993 they agreed orally that each of them would buy lottery tickets and that they would share the proceeds of any tickets that won. Many years later, in 2007, Poirier bought a ticket that won a $1 million prize, but she refused to share the prize with Browning, who sued her for his share of the winnings. Poirier denied the existence of an oral agreement and claimed that in any event any oral agreement would be unenforceable under the one-year rule of the statute of frauds. The court noted that the agreement had been in effect for many years and that the parties had intended it to last as long as their romantic relationship continued. However, the parties never fixed a definite time for the agreement to last, and it could conceivably have been performed within a year had they won the lottery in that period or if they decided to terminate the arrangement. The court noted that the question is not whether the performance is unlikely to be completed within the year but whether it cannot be performed within the year.

Not all courts adopt this approach. Some courts do not focus on the possibility that the contract could be performed in a year but instead base their determination on the contemplated duration of the contract according to the parties' understanding and the nature and circumstances of the contract. For example, in *Tucker v. Roman Catholic Diocese of Lafayette-in-Indiana*, 837 N.E.2d 596 (Ind. App. 2005), the plaintiff had been sexually abused as a child by a church employee. She agreed with the church not to pursue legal recourse in exchange for the church's promise that it would strip the abuser of his duties and would ensure that he had no contact with children at the parish. The church did not honor its promise, and the victim sued, claiming emotional distress damages for breach of contract. The court of appeals upheld the trial court's dismissal of the complaint. The diocese could have fired the abuser within the year, but its promise to ensure that he would not have contact with parish children was an ongoing obligation with no time limit. It therefore could not be treated as performable within a year.[2]

As discussed in section 11.2.3, UCC Article 2 has its own statute of frauds in §2.201 which applies where the price of the goods sold is $500 or more. Section 2.201 does not refer to the one-year rule, so it is not clear if a

contract for the sale of goods that cannot be performed within a year of its making would be subject to the common law statute as well. (Recall that under UCC §1.103(b) general principles of common law apply to sales of goods unless displaced by the provisions of the Code.) The significance of this is that if the sale agreement cannot be performed within a year, it would be subject to the common law statute, even if the price of the goods is less than $500. If the price is $500 or more, the sale agreement would have to satisfy the requirements of both §2.201 and the common law. This could make a difference if the common law requirements are more stringent.

§11.2.3 Contracts for the Sale of Goods

As mentioned above, contracts for the sale of goods are no longer covered by the traditional statute of frauds but are provided for in UCC §2.201. Section 2.201(1) requires compliance with the statute where the total price of the goods sold under the contract is $500[3] or more, so the price of all items sold under the contract must be added together to determine if it is subject to the statute. If the price consists of property other than cash, the property must be valued to establish the price.

The scope of Article 2 is discussed in section 2.7.2. In many cases a contract obviously is or is not a sale of goods. However, sometimes the nature of the contract is not so clear. This could be because it is not certain if the item sold qualifies as goods (as opposed to intangible rights or real property), or it is not certain that the transaction is a sale (as opposed to, say, a lease). It could also be because the transaction is a hybrid—it consists of both a sale of goods and the rendition of services related to them. As explained in section 2.7.2, most courts apply a predominant purpose test to decide if a hybrid transaction is subject to Article 2. Article 2 applies if the sales component is dominant, but it does not apply if the central purpose of the contract is the supply of services, with goods furnished incidentally to the service.

National Historic Shrines Foundation v. Dali, 4 UCC Rep. Serv. 71 (N.Y. 1967), is a good example of how a statute of frauds argument can hang on the question of scope. Salvador Dali, the famously eccentric surrealist painter, made an oral contract with the foundation to execute a painting of the Statue of Liberty on a television show. The painting would then be sold to raise funds for a museum. Dali reneged and defended a suit for breach of

contract on the basis that the oral contract was unenforceable under §2.201. He argued that the contract was for the sale of his painting which was worth considerably more than $500. The court rejected this argument. It found that the contract was for Dali's services in performing on TV. The fact that a painting would be created in the course of this performance was merely incidental to this purpose. By contrast, in *Power Restoration International, Inc. v. PepsiCo, Inc.*, 2015 WL 1208128 (E.D. Pa. 2015), the court held that the predominant purpose of a hybrid contract was the sale of goods so that the oral agreement was subject to §2.201. It also determined that none of the exceptions in §2.201(2) or (3) applied, so that the contract was unenforceable.

§11.2.4 Contracts to Answer for the Debt or Obligation of Another

This provision covers suretyship contracts. A surety is a person who promises the creditor to pay another person's debt, so that if the other person fails to pay the debt, the surety is obliged to pay it. For example, Borrower asks Lender for a loan. As a condition of lending money to Borrower, Lender requires someone else to agree to pay back the loan if Borrower defaults. Borrower persuades Mom, his mother, to promise Lender to pay Lender if Borrower fails to do so. Borrower is primarily liable on the loan, and is called the principal debtor. Mom, as surety, is secondarily liable. She is, in effect, a backup debtor who assumes the duty to pay a debt that she would not otherwise owe. The secondary nature of the surety's obligation is important to application of the statute. If the promisor is primarily liable on the debt (for example, she is a joint debtor) she is not a surety and the statute does not apply. (Sometimes the term "guaranty" is used synonymously with "suretyship." These two types of transactions both involve a commitment by a person to pay the debt of another, and they are very similar. The subtle differences between them need not concern us here. They both constitute contracts to answer for the debt of another and are subject to the statute.)

There are two justifications for subjecting a suretyship agreement to the statute of frauds. First, the formality of writing serves a cautionary function by alerting the surety that she is undertaking a serious, legally enforceable commitment. Second, it serves the usual evidentiary function of the statute of frauds by preventing the assertion of a possibly bogus claim that a person agreed to pay the debt of another.

The statute relating to suretyship has some difficult qualifications and nuances, which we do not get into here. However, one of them is noted briefly: The statute presupposes that the surety undertakes the suretyship for the primary purpose of accommodating and benefiting the principal debtor. Therefore, if the main purpose of the suretyship is to serve the surety's own financial interest—that is, the surety receives a direct economic benefit—the statute does not apply and an oral undertaking is enforceable. This principle only applies if the economic interest of the surety is the main purpose of the suretyship. It is not enough that the surety has some personal stake or self-interest in undertaking liability for the debt.

§11.2.5 Contracts of Executors or Administrators to Answer for the Duty of Their Decedents

The type of contract covered here is one in which the executor or administrator of an estate assumes personal liability to a creditor of the decedent for a debt or obligation incurred by the decedent before his death. That is, the executor promises the creditor that if the estate does not have the funds to pay the debt, he will pay it himself. The statute only applies to debts that the decedent incurred, not to new debts incurred by the estate itself. This provision is really just a specialized version of the suretyship provision discussed in section 11.2.4, because the executor undertakes to answer for the debt of the decedent.

§11.2.6 Contracts upon Consideration of Marriage

This category does not cover a promise of marriage, which can be and usually is oral. (It is sometimes performed by the ritual of one of the parties going down on one knee and proffering a glittery bauble to the other, but that formality is not required by law.) Rather, it relates to a contract in consideration of marriage in which the prospective spouses agree to a marriage settlement or to financial arrangements relating to the marriage. It also covers a promise by a third person (say, a parent of one of the spouses) to settle property or money on the spouses in consideration of their marriage. The requirement that the contract is in consideration of marriage means that the statute applies only to prenuptial contracts motivated by the impending marriage.

§11.3 THE SECOND INQUIRY: IF THE STATUTE APPLIES, IS THE CONTRACT REFLECTED IN A WRITING THAT SATISFIES ITS REQUIREMENTS?

To satisfy the general statute, the written memorial of agreement must comply with a number of requirements. The requirements of UCC §2.201 are similar, and any significant differences are noted below. The requirements are as follows.

§11.3.1 A Written (Recorded) Memorandum

As mentioned in section 11.1, although writing is traditionally the inscription of words on a tangible surface, such as paper, it is clear in contemporary law that "writing" includes a retrievable recording in an electronic or other medium. The word is used in that sense in this chapter. There is no particular formality needed for the writing as long as it contains the statute's minimum required content and signature. For example, you may recall that the land sale contract in *Lucy v. Zehmer* (the joke case discussed in connection with the objective test in section 4.1.6) was written on the back of a restaurant guest check. The writing need not be executed with the deliberate purpose of evidencing the contract. It need not be the joint product of the parties or even delivered to the other party. It could be an internal memorandum or a document written for some other purpose than to satisfy the statute. It need not be written at the time of contracting. (Of course, the fact that it was not a purposeful contemporaneous attempt to record the agreement could affect its credibility, but this is a different issue.) Note, however, as discussed in section 11.3.3, a memorandum written and signed by just one of the parties only satisfies the statute to the extent that enforcement is sought against the party who signed it.

The written memorandum of the contract need not be in a single document, so it is possible to satisfy the statute by a series of correspondence or other linked writings. It must be clear from the face of the writings that they all refer to the same transaction and, taken together, they must contain all the content required by the statute, including a signature on at least one of them. Some courts require the signed document to refer to the others so that the signature can be attributed to the unsigned document without extrinsic

evidence. Other courts are not as strict and require only that it is apparent from the writings that they refer to the same transaction. Oral testimony can then be used to prove that the signature was intended to authenticate the content of the unsigned writings. Provided that the writing was made, the statute is satisfied even if it has been lost by the time of litigation. Its prior existence and its contents can be proved by oral testimony. This may sound like a strange rule, given that the principal purpose of the statute is to require a written record to prevent a false allegation of contract. It could be just as difficult to detect perjured evidence of a lost writing as it is to expose a bogus claim that a contract was made. Nevertheless, when there is convincing evidence that a writing did exist at one time, this is one further safety valve that prevents abuse of the statute by a party who seeks to escape a genuine contract.

§11.3.2 The Content of the Memorandum

Evidentiary adequacy for the purpose of satisfying the statute is set quite low. All that is needed is enough writing to show the existence of a contract. Therefore, the writing does not have to contain every term of the contract and does not need to be completely clear and unambiguous in all respects. The common law and UCC have different standards for sufficiency of the memorandum, but, as usual, the looser UCC test tends to influence courts even in common law cases. Therefore, in some jurisdictions, the difference is fading.

At common law, it is generally required that the writing must at least identify the parties and the nature of the exchange, and it must set out all or at least most of the material terms. Provided that there is enough substance to show a contract, missing or unclear terms can be proved by oral evidence or otherwise resolved by the process of interpretation and construction discussed in Chapter 10.

UCC §2.201(1) provides for a less stringent standard. The only term that must be stated in the writing is the quantity of goods sold, so that the contract is not enforceable beyond the stated quantity. Beyond that, §2.201 demands only that “there is some writing sufficient to indicate that a contract for sale has been made between the parties.” It expressly states that a writing is not insufficient merely because it omits any term other than quantity, or incorrectly states any term.

Because the level of writing needed to satisfy the statute is quite minimal, it is important to recognize that a writing sufficient for the purposes of the statute may not be clear and full enough to ultimately convince the factfinder that a contract was made on the terms alleged. Compliance with the statute is a different issue from adequate proof of the contract for the purpose of relief. If the writing is skimpy or uncertain, the statute of frauds may be only the first hurdle to be jumped by the party seeking enforcement. Thereafter, the gaps or indefiniteness in the writing will have to be supplemented or cured by interpretation and persuasive extrinsic evidence.

§11.3.3 Signature

a. The Basic Rule of Signature

It is not necessary that the enforcing party signed the writing, because the evidentiary role of the statute is satisfied as long as the party disputing the existence of the contract has signed it in person or through an agent. A signature is any mark or symbol placed by the party on the writing with the intention of authenticating it, so a full and formal signature is not needed. Initials, a logo, or even an "x" is enough. The signature does not have to be placed on the writing after the terms are written down, so a party can adopt a symbol (such as a logo at the top of the page) by writing the terms of the contract on the page. UCC §1.201(37) codifies this principle by defining "signed" to include "any symbol executed or adopted with present intention to adopt or accept a writing." Restatement, Second, §134 is to the same effect. It defines "signature" as "any symbol made or adopted with an intention, actual or apparent, to authenticate the writing as that of the signer."

When the writing consists of several pieces of paper or other records (such as a series of notes, letters, or e-mails), it is not necessary that every piece has been signed, provided that it appears from the writings themselves that they all refer to the same transaction. Some courts require that the signed writing actually makes some reference to unsigned ones, but other courts require only that the writings, on their face, relate to the same transaction.

b. Electronic Signatures

Where the writing is not in tangible form, but is recorded in an electronic or other medium, the concept of signature has been adapted by federal and state legislation to include other means of verifying authorship and adopting the recorded information. The federal statute, the Electronic Signatures in Global and National Commerce Act, 15 USC §§7001 to 7031 (called E-SIGN), applies to any transaction involving interstate or foreign commerce. States have enacted equivalent statutes, either by drafting their own statutes or by adopting a uniform statute, the Uniform Electronic Transactions Act (UETA). The principal focus of the federal and state statutes is to give legal effect to electronic signatures, and they declare that a signature or other record relating to a transaction may not be denied legal effect solely because it is in electronic form (15 USC §7001(a); UETA §7). This language indicates the limited scope of the statutes. They provide that to the extent that the law requires a signature, it may not deny effect to a signature in electronic form. The statutes do not purport to deal with the question of whether the signature could be denied effect for some other reason.

"Electronic signature" is defined as "an electronic sound, symbol, or process, attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record" (15 USC §7006(5)); the definition in UETA §2(8) is almost identical. The important point to note about this definition is that it allows a distinction to be made between an identifying symbol that is automatically generated by a computer (such as the "from" line on an e-mail or the sender's identification printed at the top of a fax message) and a deliberate placing or adoption of a signature on the communication.

While the sender's deliberate typing of his name on the e-mail is quite clearly a signature, his automatically generated name (such as in the message header) is less obviously so. However, an automatically generated name can qualify as his signature if he adopts it with intent to sign the record. If the name and message are genuine, this adoption should usually occur as a matter of course, even if the sender has no specific subjective awareness that he is "signing" the communication. For example, in *International Casings Group, Inc. v. Premium Standard Farms, Inc.*, 358 F. Supp. 2d 863 (W.D. Mo. 2005), the court, applying UETA, found that the statute of frauds was satisfied by e-mail correspondence. The sender of the e-mails did not challenge their authenticity, and there was no question that they were forged. The court held that when the sender hit the "send" button, it intended to adopt

its name in the e-mail header to authenticate the e-mail, and that the header qualified as a signature. Although the automatic generation of a name may be more commonplace in electronic communications than it is in writing on paper, this concept is not new. The general definition of signature, described in section 11.3.3a, also contemplates that signature can come about if, by writing the terms of the contract on a piece of paper with his preprinted name or identifying symbol, the writer apparently intended to adopt it to authenticate the record. Note, however, that the mere fact that a party's name appears in an e-mail does not automatically mean that the party has signed the e-mail. It must be established that in generating his name, the party reasonably intended to adopt or accept the writing. For example, in *Buckles Management, LLC v. Investordigs, LLC*, 728 F. Supp. 2d 1145 (D. Colo. 2010), the court held that a defendant's name in an e-mail string did not qualify as a signature under E-SIGN, because the defendant's name was not intended as a signature. The defendant had sent an initial internal e-mail outlining terms proposed for a contract. The e-mail was then forwarded to various people, including the plaintiff, by a junior employee of the defendant (who had no authority to bind it). The court found that the mere fact that the defendant's name was on one of the e-mails in the string was not enough to constitute his signature.

With electronic signatures, as with handwritten or printed signatures on paper, a party may deny that the symbol is his signature. He may challenge the genuineness of his signature, claiming that it was forged or placed on the record by someone else without authority, or he may assert that his name or symbol on the record was not placed there with the reasonable intent to adopt or accept it. (As mentioned above, this is a particular problem where a name is automatically generated by a computer program.) In the field of electronic communications, problems of forgery and automated identification require special considerations and technological solutions. However, it is important to remember that the evidentiary issue of proving the signature exists with tangible documents as well as electronic records, and to recognize that this involves a problem of proof rather than the legal question of recognizing the validity of an electronic signature. In *International Casings* the court, in accepting an e-mail header as a signature, recognized the possibility that an e-mail message can be fraudulently generated in the name of a person who did not send it. However, the court noted that forgery is not confined to electronic communications, and this possibility should not make an e-mail header

insufficient as a matter of law where the alleged sender does not successfully impugn its genuineness.

c. Article 2's Exception to the Signature Rule Where Both Parties Are Merchants

Section 2.201(2) recognizes one situation in which a writing can be enforced against the party who did not sign it. All the following requirements must be met: Both parties are merchants; within a reasonable time of the oral contract, one of the parties sends a written confirmation to the other, which is signed by the sender and otherwise satisfies the statute as against the sender; the recipient has reason to know its contents; and the recipient does not give written notice of objection to it within ten days of receipt.

In other words, although the contract could normally be enforced only against the sender, as signatory, when both parties are merchants, the nonsigning recipient is also bound by the conduct of failing to protest after receiving a writing that should have been read. *Bazak International Corp. v. Tarrant Apparel Group*, 378 F. Supp. 2d 377 (S.D.N.Y. 2005), illustrates the operation of the merchant rule where the party seeking enforcement of the contract sends the confirmation by e-mail. The parties made an oral contract for the sale of a large number of pairs of jeans. When the seller failed to deliver the jeans, the buyer sued. The seller moved for summary judgment on the grounds that the oral contract did not comply with §2.201. The buyer successfully invoked the merchant exception in §2.201(2). The buyer had sent an e-mail to the seller setting out the terms of the sale and containing the buyer's typed name. The parties were clearly merchants, and the buyer's e-mail was sent within a reasonable time. The e-mail was a written confirmation containing the essential terms of the contract, signed by and sufficient against the sender. The focus of the opinion was whether §2.201(2) could be satisfied by an e-mail. The court found that it could be. Although an e-mail is an intangible form of communication, it is stored on the computer, is objectively observable, and can be rendered tangible. The court also found that the UCC definition of "signed" is broad enough to include the typed signature on the e-mail. Finally, the court found that the buyer had shown sufficiently for the purpose of overcoming the seller's application for summary judgment that the seller had received and had reason to know of the content of the e-mail and had not objected to it.

§11.4 THE THIRD INQUIRY: IF THE STATUTE APPLIES AND IS NOT COMPLIED WITH, DOES THE ORAL CONTRACT FALL WITHIN ANY OF ITS EXCEPTIONS?

When a contract falls within the statute and fails to comply with it, the contract is unenforceable as discussed in section 11.5. However, there are a few exceptions that permit enforcement despite the lack of a sufficient signed writing. These exceptions are narrow and specific and apply only if the party seeking enforcement can establish their elements. Each of the exceptions is justified on one or both of two grounds. One is evidentiary—the circumstances recognized by the exception tend to prove that a contract was made despite the lack of writing. The other is the protection of a party who incurred a detriment in justifiable reliance on the contract.

§11.4.1 The Part Performance Exception

Following an oral contract, the parties may begin performance, which may provide reliable evidence that a contract was made. Even if the statute applies to the transaction, the performance satisfies its function, so that refusal of enforcement would be too rigid and would allow a party to renege on an established contract through a technical application of the statute. For the part performance exception to apply, the parties' performance must be unequivocally referable to the oral agreement. That is, there must be a very clear showing that the conduct does in fact refer to and demonstrate the existence of a contract. In *Knorr v. Norberg*, 844 N.W.2d 919 (N.D. 2014), the parties entered into an oral lease that gave the lessee the option to purchase the property. Because the option related to the sale of real property, it was subject to the statute of frauds. The lessees argued that the option was enforceable under the part performance exception because they performed extensively under the agreement by making rent payments, paying real estate taxes and utilities, keeping the property insured, and physically maintaining it. The court rejected this argument, holding that the performance was not consistent only with the existence of the oral purchase option. It was just as consistent with a lease without an option. Many courts impose the additional requirement that the party seeking to enforce the oral agreement suffered some degree of prejudice in rendering performance in reliance on the

agreement.

The part performance exception is commonly raised in relation to contracts for the sale of land. Some courts recognize the exception in relation to other contracts subject to the statute, but others do not. For example, in *Coca Cola Co. v. Bayback's International, Inc.*, 841 N.E.2d 557 (Ind. 2006), the court, stating that this reflected the majority approach, refused to apply the exception to a contract that could not be performed within a year of its making.

Because the part performance doctrine is equitable in derivation, some courts apply it only where the plaintiff seeks the equitable remedy of specific performance, and not where the claim is for the legal remedy of damages. Some courts recognize an exception only if the party seeking enforcement has fully performed. The broad point is that at common law, part performance may allow enforcement of a contract that does not satisfy the statute, but the exception can be difficult to establish, and there are restrictions on its application.

Two subsections of §2.201 give limited recognition to the part performance exception when the contract is for the sale of goods. The two exceptions are narrow and apply only in specific circumstances. The first, in §2.201(3)(a), covers cases in which the seller has begun the manufacture of goods that are specially made for the buyer and not otherwise easily saleable. The second, in §2.201(3)(c), allows enforcement of the contract only to the extent payment for the goods has been made and accepted, or goods have been delivered and accepted. This means that if one party has performed and the other has accepted that performance, the party who performed can enforce the contract to recover the consideration due for the performance rendered. If only part performance has been made (that is, only part of the goods have been received or only part of the price has been paid), the contract is enforceable only with respect to what has been done but cannot be enforced with regard to the balance. In *Power Restoration International*, cited in section 11.2.3, the court held that a hybrid transaction qualified as a sale of goods under the predominant purpose test. The court went on to find that the part performance exceptions in §2.201(3) did not apply: The goods were not specially manufactured for the buyer because the seller carried them in its inventory and they were suitable for sale in the ordinary course of the seller's business, and the goods had not been delivered to and accepted or paid for by the buyer.

§11.4.2 The Judicial Admission Exception

As the statute is intended to guard against a fraudulent assertion of contract, it would seem logical that a party who admits the contract in pleadings or testimony should not be allowed to raise the statute as a defense. Nevertheless, the common law has been loath to embrace such a rule because of a concern of its impact on litigation. First, it has been perceived as creating an incentive for perjury because a party may choose to deny the contract to avoid losing the defense by an admission in litigation. Second, because a party can be compelled to disclose information in litigation, the admission may not be truly voluntary. These arguments have been criticized as inadequate to overcome the obvious relevance of admissions in litigation. The UCC has not followed them, and it does recognize a limited exception for judicial admissions under certain conditions.

The exception is specific and narrow. Section 2.201(3)(b) permits enforcement of a contract against a party, despite noncompliance with the statute if that party admits in "pleading, testimony or otherwise in court" that a contract was made. The contract is enforceable only to the extent of the quantity of goods admitted. Note that the admission must be made in connection with litigation, and the exception does not extend to admissions in other circumstances. (Of course, a written admission outside of litigation may itself be a memorandum satisfying the statute, but an oral admission in those circumstances has no effect.)

One of the more difficult issues that has arisen in connection with this exception is what constitutes an admission. Clearly, if the party breaks down under cross-examination and concedes the contract, an admission has been made. However, it could also be taken as an admission if a party's pleadings raise a defense on the merits (such as claiming that the other party breached by failure to deliver), rather than clearly denying the existence of a contract. There are also a number of procedural complexities, not addressed here, raised by the question of whether a party can be compelled to admit or deny the contract.

§11.4.3 The Protection of Reliance: Estoppel and Promissory Estoppel

Under some circumstances, equitable estoppel may be used to protect reliance on a false factual assertion. For example, if one of the parties

represents to the other that she has made a signed written note of the contract, and the other reasonably relies on this assertion. However, as equitable estoppel is traditionally confined to an assertion of fact, it is generally only helpful in a narrow range of situations.[4] Promissory estoppel is more useful when there is no factual representation inducing reliance, but one of the parties justifiably relies on the oral contract as a promise, thereby suffering some detriment.[5]

Restatement, Second, §139, a modified version of §90, recognizes promissory estoppel in this context. The elements of promissory estoppel in this situation are similar to those in §90: A promise reasonably expected to induce reliance, the inducement of justifiable reliance on the promise by the other party, and the need to enforce the promise to prevent injustice.[6] Section 139, by its express language, appears to be stricter than §90 because it specifically stresses the need for reliance of a substantial character, reasonableness by the promisee, and foreseeability of the reliance by the promisor. Despite the articulation of these requirements, §139 is not really that different from §90 in this respect, because, as the discussion in Chapter 8 shows, these elements are implicit in §90 as well.

However, §139 does have one additional element that is unique because it relates to the evidentiary purpose of the statute. One of the factors that the court should take into account in deciding to grant promissory estoppel relief is whether the promisee's conduct in reliance or other available evidence corroborates the existence of a contract. This suggests that even where part performance does not on its own create an exception to the statute, it could be a relevant factor in deciding on whether to grant promissory estoppel relief.

Section 139 does not advocate a routine application of promissory estoppel to circumvent the statute. In most cases, a party is simply not justified in relying on an oral contract, which he should reasonably have known must be in writing. Some courts have taken the position that promissory estoppel is simply not available to provide any relief where a party seeks to enforce a contract subject to the statute of frauds. *See*, for example, *DK Arena, Inc. v. EB Acquisitions I, LLC*, 112 So. 3d 85 (Fla. 2013).

Even if a court is willing to allow promissory estoppel relief and finds the reliance on the oral promise to have been justified, the detriment that the plaintiff suffered in reliance may not be substantial enough to merit enforcement of the contract. The remedy of restitution can be used to restore

any benefit of performance rendered under the unenforceable contract, so full enforcement of the contract usually exceeds what is needed to avert any injustice resulting from reliance on the oral contract. Some cases suggest that it may be almost impossible for a party to use promissory estoppel as the basis for enforcing an oral contract. For example, in the *Coca Cola* case cited in section 11.4.1, the court followed a line of cases that declined to apply promissory estoppel to enforce the oral contract itself and confined relief to substantial independent detriment. It is not clear from the opinion what that independent detriment might be, because the court found that the plaintiff was seeking to enforce the very bargain that was rendered unenforceable by the statute and refused relief. Similarly in *Brown v. Branch*, 758 N.E.2d 48 (Ind. 2001), the court refused to apply promissory estoppel to enforce an oral contract to convey land. The court said it was not enough for the plaintiff to show that breach of the oral promise resulted in a denial of her rights under the contract. She must show a substantial and independent injury for which justice demands relief. As in the *Coca Cola* case, because the plaintiff's claim was for enforcement of the benefit of the bargain, the court did not have occasion to explain what this other independent reliance might be.

It is not clear if promissory estoppel can be used to enforce a contract for the sale of goods that fails to comply with §2.201. As a doctrine of common law, promissory estoppel could supplement the provisions of §2.201 by virtue of §1.103(b), which recognizes general principles of common law unless they are displaced by the Code's particular provisions. There is no provision in §2.201 that specifically excludes promissory estoppel as a basis for excepting the sale from the statute. However, some courts have reasoned that an intent to exclude promissory estoppel can be inferred from the first words of §2.201, "[e]xcept as otherwise provided in this section," followed by the listing of a defined set of specific exceptions in §2.201(3).

§11.5 THE IMPACT OF NONCOMPLIANCE WITH THE STATUTE

There is some variation in the statutes of different states and some confusion in the caselaw about the effect of failure to satisfy the statute. The noncompliant contract is sometimes said to be invalid or void—that is, a legal

nullity, of no force or effect. Sometimes it is called unenforceable—that is, a contract that is valid but cannot be sued on and enforced in court. Some cases use these words interchangeably. It is more generally accepted that noncompliance with the statute does not void the contract, but merely makes it unenforceable. Although there are instances in which consequences follow from characterizing a contract as void rather than unenforceable, the distinction is not practically significant for most purposes. In either case, the plaintiff is unable to sue on the contract.

If the contract is unenforceable for noncompliance with the statute, the party seeking to rely on the statute as a defense cannot raise it by a general denial. It must be specifically pleaded as an affirmative defense, otherwise it is waived. If the defense is raised and succeeds, the contract cannot be enforced. If neither party has given or done anything under the contract, the practical effect of nonenforcement for most purposes is to put an end to any obligations that the parties might otherwise have had under the contract. However, sometimes a party may have rendered some performance before the contract was declared unenforceable. (Obviously, this partial performance could not have been sufficient to except the contract from the statute as discussed above.) Once the contract is unenforceable, the party who received the performance no longer has a right to keep it. It must therefore be returned under principles of restitution. If it was a money payment or the delivery of property still in the hands of the beneficiary, the money or the property itself must be restored. If it was services or property that has been consumed, restitution is usually measured based on its market value, but the court has the discretion to value it differently if fairness so dictates.[7]

§11.6 THE EFFECT OF THE STATUTE OF FRAUDS ON MODIFICATIONS OF A CONTRACT

Obviously, neither party can unilaterally change the terms of a contract after it has been made, but a contract can always be modified by agreement between the parties. A modification is a contract in itself, distinct from the original contract that it changes. As a separate contract, it is subject to most of the usual requirements of contract law for formation and validity.[8] As a general rule (unless the statute of a particular state provides otherwise), this

means that the statute of frauds applies to modifications. Therefore, whether or not the original contract was subject to the statute, if the contract as modified falls within the statute, the modification must be recorded in a writing sufficient to satisfy it.[9] For example, under an original contract, entered into on July 1, 2016, a customer booked a room at a resort for July 3 and 4, 2017. As the contract cannot be performed in a year, it is subject to the statute. Two weeks after making the contract, the customer called the resort and the parties agreed to change the booking to December 25 and 26, 2016. The statute no longer applies to the modified contract. The opposite would occur if the original booking was for December 25 and 26, 2016, and was changed to August 3 and 4, 2017, dates more than a year after the modification. The statute did not apply to the original contract, but it does apply to the modification.

§11.7 A TRANSNATIONAL PERSPECTIVE ON THE STATUTE OF FRAUDS

Neither the CISG nor the UNIDROIT Principles contain a statute of frauds. This comports with the civilian tradition of not generally requiring the formality of writing for the validity or enforcement of a commercial contract. CISG Article 11 states that a contract of sale is not subject to any requirements of form, and need not be evidenced by a writing. However, Article 11 is qualified by Article 12, which does allow a signatory country to opt out of Article 11 with regard to a party that has its place of business in that country. If the country exercises its power to opt out, the statute of frauds provided for in its domestic law will apply. (The United States has not exercised the power to opt out, so the Article 2 statute of frauds does not apply to a transaction governed by the CISG.) Article 1.2 of the UNIDROIT Principles follows the same approach as CISG Article 11 in not requiring any writing or other formality to validate a contract. It is also worth noting that England, the country from which we derived our statute of frauds, abolished it some years ago.

Examples

1. On May 15, Viva Voce, the president of Ritten Records, Inc.

interviewed Juan Annum for the position of sales manager. The parties reached agreement on a one-year period of employment, beginning on June 1 at an annual salary of $150,000. At the end of the interview, Viva tore a piece of paper from a blank pad and wrote, “Call personnel dept. to enroll Juan Annum as a sales mgr.—1-yr contract starting 6/1. Pay $150,000 p.a.” She told Juan that the purpose of the note was to remind her to call the personnel department so that they would put him on the payroll from June.

After the meeting, Juan resigned from his current employment by giving the required two weeks’ notice. On May 17, he received a memo in the mail from the personnel department of Ritten Records, Inc. It was written on the company’s letterhead and said simply, “We understand that you will be joining us on June 1. Please come in as soon as convenient to fill out the necessary tax forms.”

On May 23, before he had a chance to go to the personnel office, Juan received a letter in the mail from Viva on the company’s letterhead. It read:

> Dear Juan,
>
> I was happy to be able to extend an offer of employment to you last week. I regret, however, that since then we have reevaluated our earnings for the last quarter and find them disappointing. We have therefore decided not to hire any new employees at this time. I am sorry that we cannot use your services. I am sure that a person of your talents will have no difficulty in finding a suitable position elsewhere.
>
> Sincerely,
> Viva Voce
> President

Can Ritten Records, Inc. get away with this?

2. Change the facts of Example 1 as follows: Viva did not send the letter of May 23 and Ritten Records still wished to employ Juan. However, on May 23 Juan received a better job offer and is no longer interested in working for Ritten Records. Apart from this, all the facts are the same as in Example 1. Can the company enforce the contract against him?

3. Clay Potter owns a pottery in which he manufactures ceramic ovenware and crockery. Terry Cotta sells such items in his retail store. On June 1, Terry called Clay and spoke to his assistant who accepted his order of 1,000 ceramic mugs of various designs at $5.10 each, for immediate

delivery. Later that day, Terry mailed the following printed form to Clay, with the blanks filled out by hand (the handwriting is denoted here by italics):

> TERRY'S HOUSEWARES. Terry Cotta, Proprietor.
> PURCHASE ORDER
> Date: *June 1, 2016*
> To: *Clay Potter*
> Please ship the following goods immediately: *1,000 assorted mugs as discussed by phone at $5.10 each*

On June 6, Terry received the following letter from Clay:

> Dear Mr. Cotta,
>
> I have received your order of June 1. I am sorry that I am out of mugs at present and cannot supply them right now. I am in the process of making a new batch and should have them in stock next month. Due to increased costs, I am going to have to raise the price to $5.50 each. If you would like me to hold your order until that time let me know. Also, tell me which designs you want. Your order refers to an assortment as discussed by phone, but no one here remembers talking to you and we have no record of your call.
>
> Yours truly,
> Clay Potter

Terry claims that he already has a contract for immediate delivery at the old price. Can he enforce it against Clay?

4. a. Fresco Fantastico is a famous, top-selling artist. Ore Alloys, Inc. (ORAL) was in the final stages of completing the construction of a new headquarters building. On March 1, 2016, it entered into an oral contract with Fresco under which it commissioned him to paint a 15 foot by 35 foot mural of its ore smelter on the wall of the building's lobby. The parties agreed that Fresco would begin the mural on May 1, 2016 (the date on which the lobby would be ready for decorative work) and would complete it by not later than June 1, 2017. ORAL would pay Fresco $100,000 on completion of the mural. On March 25, 2016, before Fresco had done any work or preparation under the contract, the president of ORAL called and told him that the corporation had changed its mind and no longer desired the mural.

Does the statute of frauds preclude Fresco from enforcing his contract with ORAL?

b. Change the facts of Example 4(a) as follows: The oral contract between Fresco and ORAL on March 1, 2016, was not for a mural, but for a 15 foot by 35 foot painting of the ore smelter on canvas for $100,000. Fresco would complete the painting in his studio and deliver it to ORAL by not later than June 1, 2017. On March 15, 2016, Fresco had a large canvas made to fit the space in the lobby and he began to rough in the outlines of the painting. On March 25, the president of ORAL called and told him that the corporation had changed its mind and no longer desired the painting. Does the statute of frauds preclude Fresco from enforcing his contract with ORAL?

5. Annette X. Plorer visited the Web site of Big Browser Megastore.com and selected a Rolex watch for $10,000. She ordered it by clicking on various links; keying in her name, address, and credit card particulars; and finally clicking a "confirm order" button to confirm her order. After she did this, a message appeared on her screen thanking her for her order and stating that the goods would be shipped in 10 to 20 days. Assuming that a contract was formed through this process, does it satisfy the statute of frauds?

6. Sissy and Sybil Sibling are sisters. They were very close and made regular trips together to Atlantic City, where they played on the slot machines. About a year ago, they entered into an agreement under which they each promised that they would share any gambling winnings that either of them made. They recorded this agreement in a writing that read, "Sissy and Sybil Sibling hereby agree that for a period of two years from the date of this agreement, they will share any gambling winnings that either of them make in playing the slot machines in Atlantic City." Both sisters signed the writing. During the next eight months, the sisters visited Atlantic City three times. Each made modest winnings on the slot machines and they shared them. Eight months after signing the agreement, the sisters had a ferocious argument about a family matter and ceased speaking to each other. In a heated telephone call during the course of this argument, Sissy said, "As for our agreement to share our gambling winnings, you can forget that!" Sybil replied, "That's fine with me." A month later, Sissy went to Atlantic

City on her own and won $20,000 on the slots. When Sybil heard about this, she sued Sissy for $10,000. Sissy contends that Sybil has no claim against her because they agreed to terminate their contract to share gambling winnings. Is this contention correct?

Explanations

1. Although the letter of May 23 suggests that the company is revoking an unaccepted offer, it is clear that an oral contract was made between Juan and the company, represented by its president, on May 15.

   The first question to answer is whether the contract is subject to the statute of frauds. The only applicable provision of the statute is that covering contracts not to be performed within a year. Although the performance itself will take exactly one year, it is not the length of actual performance that is crucial, but the time between making the contract and the end of performance. This period is approximately two weeks longer than a year. When there is some flexibility in the length of performance, the contract is not treated as falling within the statute if performance could conceivably be completed within the year, but this is not the case here because this is a fixed-term contract. Could it be argued that the performance could end before a year because the employee might die before that time? Although a court is more likely to accept this reasoning when the contract contemplates termination by death (for example, a lifetime employment term), it may be more hesitant to do so if death would merely be a discharge of the duty to perform. However, given the resistance to the one-year rule, it is possible that a court would be willing to entertain an argument that the mere possibility of death makes the contract performable within a year. Of course, such an interpretation would go a long way toward gutting the rule.

   If the contract is subject to the statute, the next question is whether there is a writing to satisfy it. To comply with the statute, there must, at a minimum, be a written record, signed by the party against whom enforcement is sought, identifying the parties, setting out the nature of the exchange, and containing most, if not all, of the material terms. The writing need not be contained in a single document, but can be made up of a set of linked documents. Three documents are referred to in the question: Viva’s note to herself, the memo from the personnel

department, and the letter from Viva. None of these documents on its own is sufficient to satisfy the statute.

Viva's note to herself probably has enough content to show that a contract was made for a year's employment, and it seems to contain the central terms that were agreed. However, it lacks two elements needed to satisfy the statute: First, it identifies only one of the parties, Juan, and gives no indication of who the other party is—it makes no reference to Ritten Records. It is usually a requirement of the statute, in its common law version, that the writing must identify the parties. Second, the note is devoid of any kind of mark or symbol that could satisfy the requirement of a signature, even under the liberal definition of signature used in Restatement, Second §134 ("any symbol made or adopted with an intention, actual or apparent, to authenticate the writing as that of the signer"). Had the piece of paper contained the company name or logo, or had Viva signed or initialed the note, this would have satisfied the requirement of signature, but she wrote the note on a blank piece of paper and placed no mark on it that could constitute a signature.[10]

Therefore, the absence of a signature by or on behalf of Ritten Records prevents the note from being an adequate memorial of agreement. Had the note been signed, it would not have mattered that the note was intended as an internal document. The writing need not be addressed or given to the other party. The facts do not state if the note is still in existence, so it is possible that Viva may have crumpled it up and thrown it away after calling the personnel department. However, this would not necessarily be fatal to Juan's case because as long as he can prove the existence and contents of the note at an earlier time, it need not still be extant at the time of suit. (Of course, if Viva denies writing the note or disputes what it said, Juan's success in his suit will be heavily dependent on his credibility. This is not a happy situation for a plaintiff, who could easily fail to discharge his burden of proof.)

The memo from the personnel department was written on company stationery and exhibits its logo. The preexisting printed logo should qualify as a signature because Ritten Records adopted it when using the preprinted stationery. The memo also identifies Juan and suggests the existence of a contract. However, the memo does not set out the terms of the contract. Although some degree of omission is tolerated, an indication of the central terms is usually required. In particular, there is

no way to tell that this was not a contract for employment at will because of the lack of reference to the period of employment.

Viva's letter of May 23 is signed, but it is of little help to Juan because it does not in any way evidence a contract. In fact, it is written to suggest just the opposite because it is phrased like the revocation of an unaccepted offer.

Although no single document sufficiently complies with the statute, taken together two of the three writings may contain all the content needed to satisfy it. As discussed in section 11.3.1, a set of writings in combination can satisfy the statute if, on their face, they refer to the same transaction and together they include all the required content. (Some courts insist that the signed document actually refers to the unsigned ones, but other courts find that test too rigorous and require only that it is apparent from the writings that they refer to the same transaction.) If Viva's note exists or can be convincingly shown to have existed, and the logo on the personnel department's memo is accepted as a signature, these two writings should be viewed in combination because they both refer to the same transaction. (Although Viva's letter of May 23 has a stronger form of signature, its implicit denial of a contract probably disqualifies it as referring to the transaction in a probative way.)

If the statute applies and Juan does not succeed in establishing compliance with it, he cannot enforce the contract unless he can fit it into one of the recognized exceptions to the statute. The only exception that might apply is promissory estoppel, based on the argument that Ritten Records made a promise in the oral contract, reasonably expecting to induce Juan's reliance, he did justifiably rely on the promise and suffered a substantial detriment in resigning from his existing job.[11] The problem with this argument is that Juan is responsible for knowing the law, and there is no apparent justification for his reliance on an oral contract. If ignorance of the need for a writing is enough to invoke promissory estoppel, the statute would be routinely circumvented.

2. Although Juan may be able to overcome the statute of frauds problem and enforce the contract against Ritten Records, the company has no corresponding right. When the writing has been signed by just one of the parties, the statute makes the contract enforceable against that party

only. If the rule were otherwise, the statute would have little purpose because it would be too easy for one of the parties to write and sign a bogus document and to claim a contract binding on the other. (The UCC has a limited exception to this rule, discussed in section 11.3.4 and the next Example.) Juan has not signed anything. There is also no basis for Ritten Records to invoke promissory estoppel because it has taken no action in reliance on Juan's oral promise.

This means, of course, that Juan might be able to enforce a contract against Ritten, but Ritten has no basis to enforce a contract against him.[12]

3. Although the price of each item of goods is only $5.10, they are sold together in a single contract, so the price of the sale is their total price of $5,100. The contract is therefore subject to the statute of frauds in UCC §2.201. Terry is the party who seeks to enforce the contract, so the first question to ask is if Clay's letter satisfies the statute. It does not. Although Clay's letter is signed ("signed" is defined in §1.201(37) as "any symbol executed or adopted by a party with present intention to authenticate a writing"), it fails to satisfy §2.201(1) because it does not indicate that a contract has been made. In fact, phrased as a counteroffer, it suggests just the opposite. Terry's order form would satisfy the statute as against Terry, but it does not satisfy §2.201(1) as against Clay because it must be signed by the party against whom enforcement is sought. If this was a contract at common law, this would end the matter —Terry could not enforce the oral agreement against Clay.

   However, if all its requirements are satisfied, UCC §2.201(2) provides an exception to the rule that that contract must be signed by the party against whom it is to be enforced. If one of the parties sends a confirmation of the oral contract to the other, the statute is satisfied as against the recipient if all the following conditions are satisfied: both parties are merchants; the writing is sufficient under §2.201(1) to satisfy the statute as against the sender; it was sent within a reasonable time; it was received by the other party who has reason to know its contents; and the recipient does not give written notice of objection to it within ten days of receipt.

   Both parties are merchants under §2.104(1) because they both deal in goods of that kind. For the writing to be sufficient against Terry, the sender, it must indicate that a contract of sale has been made between

the parties and must be signed by Terry. Beyond this, it need not accurately or fully state all the terms agreed, but it is not enforceable beyond the quantity stated. The order form does set out the essential terms of the contract, including the quantity of the goods. Terry's printed name at the top should qualify as his signature because it was adopted by him to authenticate the form when he filled out the blanks. The only problem is that the form is described as an order, which suggests not a contract, but an offer. It would have been clearer if the form had been headed "order confirmation." Nevertheless, this difficulty can be overcome by the reference to the telephone call that, on a reasonable interpretation, suggests a prior oral order accepted by or on behalf of Clay.

The form was sent on the same day as the telephone call, surely within a reasonable time, and Clay's response shows that it was received and its contents read. All is well for Terry so far, but Clay's letter could constitute a written notice of objection. To be an effective objection to the contents of the writing, the response must challenge the existence of a contract. Although the letter from Clay does not say in so many words that it denies Terry's claim of a contract, its import is clearly to that effect. It treats the order as an offer and claims no knowledge of the telephone call. It is in writing and is given within ten days of receipt of Terry's form.

4. a. The contract to paint the mural on the lobby wall is a hybrid transaction involving the supply of goods (paint) and services (applying the paint). As discussed in section 2.7.2, where a contract contains both a sale of goods and the performance of services, most courts apply a predominant purpose test to decide if the contract is subject to UCC Article 2. If the sale of goods is the more significant aspect of the transaction, Article 2 applies, but if services predominate, it does not. There can be no doubt that the parties did not intend to contract for the supply of paint, but for the skills that Fresco would employ in painting the mural. Undoubtedly, Fresco's labor predominates over the materials, both in value and scope. Because the service element is predominant, Article 2 does not apply and the contract is not subject to the statute of frauds in §2.201.

The only category of the common law statute that could apply to this contract is the one-year rule. Fresco was given 15 months from

the date of the contract to complete the painting. However, there is no contractual bar to his finishing it earlier. It does not matter that the scope of the work is so large that he may not be able to get it done within a year of the contract. Courts generally interpret the one-year rule restrictively, and do not find it applicable to a contract unless by its terms, it clearly requires the performance to continue for more than a year. The statute of frauds does not preclude Fresco from enforcing his contract with ORAL.

b. While it may seem that Fresco has contracted to perform a service by painting the picture, all his work goes into the creation of a tangible, movable end product. Where the delivery of the end product of labor is the subject matter of the contract, it is a sale of goods, even if the seller's labor in making the goods exceeds the cost of materials. Fresco's contract in this Example is therefore quite different from the contract to paint a mural in Example 4(a) and is also distinguishable from that of his colleague, Salvador Dali, whose undertaking to paint a picture on a TV show was characterized as a contract for services. (*See* section 11.2.3.)

The sale price of the painting is $100,000 so the contract is subject to the statute under §2.201. There is no writing at all, so the statute is not satisfied unless one of the exceptions in §2.201(3) applies. The only exception that has any possible relevance is the version of the part performance exception set out in §2.201(3)(a). To invoke this exception, Fresco must show that the goods are to be specially manufactured for the buyer; they are not suitable for sale to others in the ordinary course of the seller's business; before receiving notice of the buyer's repudiation, the seller made a substantial beginning on their manufacture or commitments for their procurement; and the circumstances reasonably indicate that the goods are for the buyer.

Very clearly, the exception has its basis in the principle, recognized to some extent at common law too, that the statute should not be applied to defeat relief to a party when post-formation conduct both indicates detrimental reliance on the oral contract and provides evidence of the contract's existence. By commencing performance or procurement of goods that are specific to the buyer's needs and not readily resalable, the seller incurs prejudice and his actions

demonstrate the existence of a contract.

In Fresco's case, the painting is especially commissioned by and reflects a theme of particular interest to the buyer which strongly indicates that the painting is for the buyer. It is not clear if Fresco would be able to sell the painting to someone else in the ordinary course of business. There may or may not be much demand for an oversized painting of ORAL's smelter.

Fresco bought the canvas and began the painting before the repudiation. Is this a substantial enough beginning? This requirement, combined with that of difficulty of resale, is intended to confine the exception to cases in which nonenforcement would cause hardship to the seller. It is difficult to draw a definite line at which the commitment of time and materials passes from insubstantial to substantial, but Fresco could make a respectable argument that the purchase of the canvas, a major component of the materials to be used, the time spent in conceiving the painting, and the preliminary blocking work is enough to be substantial. However, as the canvas has not been consumed and could be used for another painting, this is not an overwhelming argument.

In short, the performance seems to serve the evidentiary function well, but is less compelling on the question of detriment. Fresco has a chance of success, but this is not an easy case to predict.

5. This is a sale of goods for a price of $10,000 so it falls within §2.201 and there must be a written memorandum of agreement, signed by the party against whom enforcement is sought, sufficient to show that a contract has been formed.

There is no doubt that the electronic records generated in the computers of both parties satisfy the requirement of §2.201 that there be a record sufficient to indicate a contract of sale. Annette's order, with particulars of the parties, the goods, the price, and the quantity term, accepted by Big Browser with the delivery information, surely evidences the existence of a contract. Contemporary courts interpret the word "writing" in §2.201 to include electronic records. The question of the effectiveness of the parties' signatures is settled by E-SIGN and UETA, both of which require the court to give effect to the electronic signatures of the parties, provided that such electronic signatures exist and they are genuine and otherwise in conformity with the law. The

facts present no question of forgery or unauthorized use of equipment, so the sole issue is whether the parties did execute or adopt a symbol associated with the contract. The facts indicate that Annette deliberately entered her name in the appropriate space on the electronic order form. Undoubtedly this qualifies as her signature.

Although the facts do not specify, Big Browser's name or symbol surely appears in its response. If an employee handled the response and typed Big Browser's name or symbol, this qualifies as its signature. Even if the employee did not actually type the name or symbol, the employee's act of sending the message under an automatically generated name or symbol likely constitutes the adoption of that name or symbol with the intent to authenticate the record. Big Browser's response may not have been made by a human at all, but could have been automatically generated by a computer program used by Big Browser. This should not make a difference to the conclusion that its name or symbol should qualify as a signature. Section 5.8 explains that a party can contract through an "electronic agent"—a computer program that is set up to initiate action or respond automatically to a communication. UETA recognizes this possibility in §14, and comment 1 to §14 points out that intention to enter into a transaction can be attributed to a party who sets up a machine to act as his agent. Therefore, attribution of signature to a party should be possible where the automatic signature is by a machine programmed to be an electronic agent.

6. The agreement to share gambling winnings is subject to the statute of frauds because it has a definite term of two years and therefore cannot be performed within a year of execution of the contract. However, the signed written agreement to share winnings satisfies the statute, so Sissy cannot claim that the original agreement is unenforceable. Instead, she argues that the agreement was rescinded by mutual consent. The sisters did enter a termination agreement through an offer by Sissy that was accepted by Sybil. The agreement is supported by consideration because each suffers the detriment of giving up her rights under the terminated contract. If that termination agreement is enforceable, Sissy has a good defense to Sybil's suit. However, the termination agreement is oral, so the question is whether it is subject to the statute of frauds. If it is, the oral termination agreement is unenforceable, and Sybil does have a cause of action under the original contract. An agreement to terminate a

contract is itself a contract. Like a modification, it is subject to all the usual rules relating to formation and validity, and it must comply with the statute of frauds if it falls within the statute. The argument could be made that it is subject to the statute of frauds because the underlying contract still had more than a year to run, so the agreement to terminate rights under the contract must last just as long and cannot be performed within a year of its making. However, that is not persuasive. It is better to view the termination agreement as taking effect immediately, and being fully performed as soon as each party commits to give up her rights under the terminated contract.

This is what the court held in *Sokaitis v. Bakaysa*, 49 Conn. L. Reptr. 812 (Conn. Super. 2010), on which this Example is based. Two octogenarian sisters enjoyed gambling at a casino and buying lottery tickets. They had made a written agreement to share their gambling winnings. Their formerly close relationship ended when they had an argument over a loan that one of the sisters made to the other. During the course of an argument over the loan, there was a heated exchange in which one of the sisters said, "I don't want to be your partner anymore," and the other replied, "OK." Thereafter, one of the sisters bought a Powerball lottery ticket with her brother and they won $500,000. Upon hearing of this, the other sister sued for breach of the contract to share gambling winnings. The court noted that an agreement to rescind a contract is itself a contract. An effective agreement of rescission ends the contract and waives all rights to enforce or sue on it. The court found that the sisters had entered into a valid agreement to rescind the contract. It held further that the rescission agreement was not subject to the statute of frauds because the rescission involved an instantaneous performance under which each party's duties under the original contract were immediately discharged.

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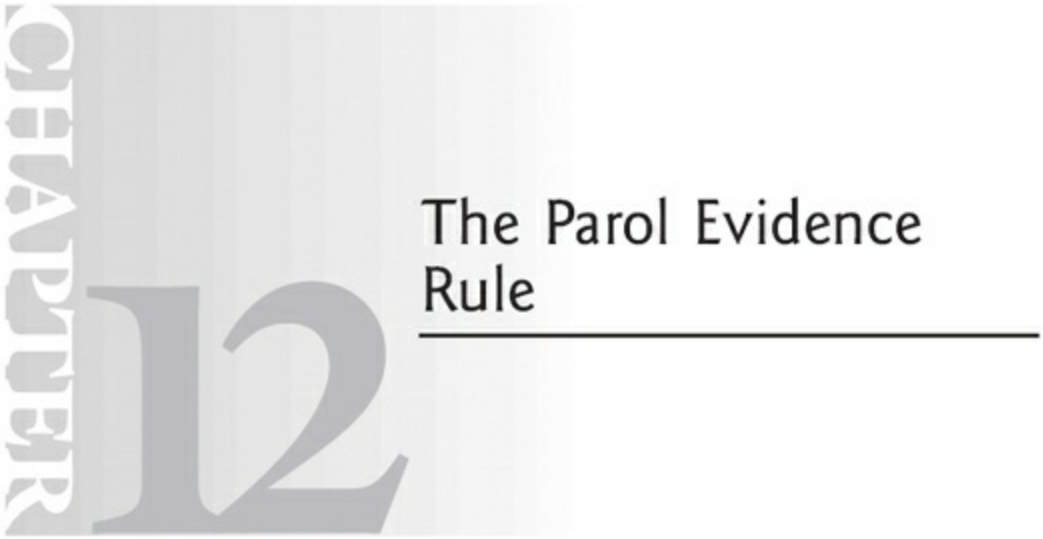
1. The statute covered many types of transactions besides contracts. We are concerned only with its relationship to contracts.

2. Apart from noncompliance with the statute of frauds, the court found other problems with the plaintiff's case. The contract was invalid for lack of consideration because the statute of limitations had already run on the plaintiff's claim at the time that of the parties' agreement, so she suffered no legal detriment in forbearing from suit. In addition, the court held that emotional distress damages are not available for breach of contract. (*See* section 18.13.)

3. Five hundred dollars is the amount that was set in the original enactment of Article 2 about 60 years ago, and it has never been increased to account for inflation. The failed attempt to revise Article 2 in 2003 would have increased the amount to $5,000. Some states have amended their version of §2.201 to increase the amount.

4. The elements and purpose of equitable estoppel are explained in section 8.4.
5. Promissory estoppel is discussed fully in Chapter 8.
6. In *Tucker v. Roman Catholic Diocese of Lafayette-in-Indiana*, discussed in relation to the one-year rule in section 11.2.2, the plaintiff also asserted the promissory estoppel exception to the statute of frauds. The court of appeals upheld the trial court's dismissal of the claim on this ground as well. Because the statute of limitations had run on the plaintiff's claim when the diocese made the promise, she could not have sued anyhow, so she suffered no detriment in forbearing from suit in reliance on the promise, and there was no need to enforce the promise to prevent injustice.
7. The measurement of restitutionary benefits is discussed more fully in section 9.6.
8. As discussed in sections 7.5 and 13.9, at common law one of these requirements is that the modification must be supported by consideration. However, Article 2 dispenses with the need for consideration to support the modification of a contract for the sale of goods.
9. Even if the modification would not otherwise be subject to the statute, the contract may provide that all modifications must be in writing and signed. Such a provision can be effective as a kind of contractually created statute of frauds which prevents the enforcement of an oral modification. However, courts sometimes uphold oral modifications notwithstanding the provision. This is discussed in section 12.12.
10. You may be tempted to argue that Viva could be taken to have signed the note merely by writing it—after all, a handwriting expert could identify the writing as hers. However, that argument does not work. The requirement of signature—the making or adoption of a symbol to authenticate the writing—is a requirement independent of the writing itself.
11. You may recall that section 8.10 discusses the problem of showing justifiable detrimental reliance on a promise of at-will employment. That issue does not arise here because the contract was for a one-year term. The issue here must be distinguished—it is whether promissory estoppel can be used as a means of enforcing an oral contract that is subject to the statute.
12. Although Juan may be able to enforce the contract against Ritten Records, and the company has no basis to enforce the contract against him, this does not give rise to a problem of "mutuality of obligation." As discussed in section 7.9.1, provided that both parties' promises are genuine and not illusory, there is no general rule of "mutuality" that prevents one party from being bound because the other has no right of enforcement.



§12.1 THE APPLICATION AND BASIC PURPOSE OF THE PAROL EVIDENCE RULE

§12.1.1 A Written or Recorded Agreement

The parol evidence rule applies when an agreement is recorded, whether in writing on paper or in an electronic record, and one of the parties proffers evidence to prove a term that is not contained in the record or to explain or expand on a term in the record. (Because the parol evidence rule traditionally refers to a "writing," and that word is used in the Restatement, Second; UCC Article 2; and many cases, this chapter follows the convention of using the word as well. However, do not forget that it is used in a broad sense to cover not only words on paper but all forms of recording by electronic or other means.)

§12.1.2 The Relationship Between the Parol Evidence Rule and Interpretation

The parol evidence rule is closely intertwined with the process of interpretation. As you read this chapter, you will see many links to the discussion of interpretation in Chapter 10. The following general observations on the relationship between the parol evidence rule and interpretation should help keep things straight.

Although there are some passing references to the parol evidence rule in Chapter 10, that chapter was concerned purely with the rules and principles governing the interpretation or construction of contracts to determine the parties' reasonable meaning. The central point of Chapter 10 is that unless there is no evidence of context available, the meaning of language used in the contract is usually determined not purely by reference to the dictionary meaning of the words but by evaluating the meaning of the words in the entire context of the transaction. This context may include the discussions between the parties in forming the contract, their previous course of dealing in prior contracts of the same kind, trade usage, and their post-formation course of performing the contract. Where the agreement has been recorded, the parol evidence rule qualifies what was discussed in Chapter 10 by placing controls on recourse to this extrinsic evidence. In short, it restricts the extent to which some contextual evidence may be considered in deciding what the parties intended in entering the contract.

The impact of the parol evidence rule on the contextual evidence used to interpret the contract depends both on the completeness and clarity of the written record of agreement and on the quality of the contextual evidence. The clearer and more comprehensive the writing, the higher the barrier to the admission of extrinsic evidence. On the other hand, the more compelling the extrinsic evidence, the greater the prospect of persuading the court that it should be admitted. Of course, to decide whether the writing is clear and comprehensive, the court must interpret the writing itself. The effect of this is to create a circular process that can be confounding: the parol evidence rule impacts interpretation by restricting evidence extrinsic to the written contract, but interpretation, often in the light of that very extrinsic evidence, must be used to decide whether and to what extent the writing should have the effect of excluding the extrinsic evidence. One of the most difficult tasks in understanding the parol evidence rule is to appreciate how courts navigate this circular route. As you read this chapter you will find a central theme emerging: Courts try to strike a balance between the parties' reasonable expectations that arise from the language of the written contract and their

reasonable expectations that arise from the context in which that written contract was formed.

§12.2 A BASIC STATEMENT OF THE RATIONALE AND CONTENT OF THE RULE

The parol evidence rule is based on the principle that when the parties record their agreement in writing, they often intend the written record to be the final expression of their agreement. That is, they intend it to supersede anything that might have been proposed, discussed, or agreed to prior to execution of the writing but not ultimately recorded in it. Accordingly, the factfinder should not hear evidence of terms that were allegedly agreed to but are not reflected in the writing. This evidence is suspect, unreliable, and irrelevant, and is more likely to mislead and confuse than to inform the factfinder. (This rationale is taken up again and illustrated in section 12.3.)

Restatement, Second, §213 sets out the common law parol evidence rule, as it is applied by many contemporary courts. The UCC rule, in §2.202, is worded somewhat differently, but is largely similar in effect. In essence, both versions of the rule provide that to the extent that the parties execute a writing that is and is intended to be a final expression of their agreement, no parol evidence may be admitted to supplement, explain, or contradict it. However, to the extent that the writing is not a final and complete expression of agreement, consistent, but not contradictory, parol evidence may be admitted to supplement or explain those parts of it that have not been finally expressed.

§12.3 WHAT IS PAROL EVIDENCE?

§12.3.1 The Meaning of "Parol"

"Parol" is derived from the French *parole*, meaning "a word"—more particularly a spoken or oral word. It has the same etymological root as the more familiar modern English word "parole," which has now developed the specialized meaning of a prisoner's early release from jail subject to

conditions. Because contract lawyers do not like in any way to be associated with criminal activity, do not use that final "e" when referring to parol evidence.

Although the derivation of "parol" suggests that it refers only to oral terms, it extends to written terms as well under some circumstances. In short, the rule covers both oral and written terms allegedly agreed to prior to execution of the written contract, but not incorporated into the final written contract. It also covers terms allegedly agreed to orally at the time of the written contract, but not incorporated into the written contract.

§12.3.2 Terms Allegedly Agreed to Prior to the Written Contract

The parol evidence rule covers evidence of an alleged term not incorporated into the final written agreement, but claimed by one of the parties to have been agreed to, either in writing or orally, at some time before the execution of the recorded agreement. For example, Seller and Buyer sign a written agreement under which Seller sells her car to Buyer for $5,000 cash, to be paid on delivery of the car. When Seller thereafter tenders delivery of the car, Buyer refuses to pay the $5,000, claiming that on the day before the agreement was signed, Seller had orally agreed to give him 30 days' credit. If this matter should eventually be litigated, Buyer's testimony about the prior oral agreement would be parol evidence. (As we will shortly see, it most likely satisfies all the elements of the parol evidence rule, and the court would therefore refuse to allow Buyer to testify about the prior oral agreement.) The rationale for filtering such evidence through the parol evidence rule is that an allegation of prior consensus on an oral term is suspect when the oral term is not incorporated into the writing executed for the purpose of memorializing the agreement. Its absence from the writing suggests either that it is a complete fabrication by Buyer, or even if it was agreed to, that the parties intended to supersede it by the written term. Therefore, the evidence should be evaluated with special care by the judge before it is admitted for the factfinder's consideration.

Say that Seller and Buyer negotiated the contract for the sale of the car by correspondence, not orally. Their correspondence shows agreement on a 30-day credit term, but their final written contract of sale states that the car must be paid for in cash on delivery. The evidence of prior agreement is parol evidence, even though it was written. Although the presence of objectively

verifiable written evidence of prior agreement reduces concern that Buyer made up the claimed agreement on the credit term, its absence from the final writing still suggests that the parties must have intended to supersede it by the cash term.

§12.3.3 Terms Allegedly Agreed to Contemporaneously with the Written Contract

Although the parol evidence rule applies to both oral and written evidence of agreement allegedly made prior to the execution of the final writing, it covers only evidence of oral agreement made contemporaneously with the final writing. The bar on evidence of contemporaneous oral agreement does not extend to evidence of contemporaneous written agreement. There are two reasons for this. First, the existence of a writing is more reliable evidence of agreement than oral testimony. Second, a contract need not be contained in a single document, so that where there are contemporaneous writings, it may not be clear that one of them was intended to supersede the other. They may simply be supplementary to each other. As a result, the parol evidence rule allows any contemporaneous writings to be admitted. (As explained more fully in section 12.6, admission of the evidence is just a preliminary matter. It allows the evidence to be placed before the factfinder. It does not mean that the factfinder will ultimately conclude that the final agreement is reflected in both writings. It may find that one supersedes the other.)

The type of evidence of contemporaneous oral agreement that is subject to the rule can be illustrated by changing the above example involving the sale of the car. Say that Buyer wishes to testify that when the parties got together to sign the sales contract, he raised the issue of credit and Seller agreed to give him 30 days to pay for the car. However, this agreement is not reflected in the writing. Buyer's assertion is as or more suspect as his claim of a prior oral agreement and is equally subject to the rule.

§12.3.4 Evidence of Subsequent Agreement

The parol evidence rule does not affect evidence of either oral or written agreements claimed to have been made after the execution of the writing. The theory behind the parol evidence rule is that the writing is likely to have subsumed all prior understandings, and this presumption cannot have any

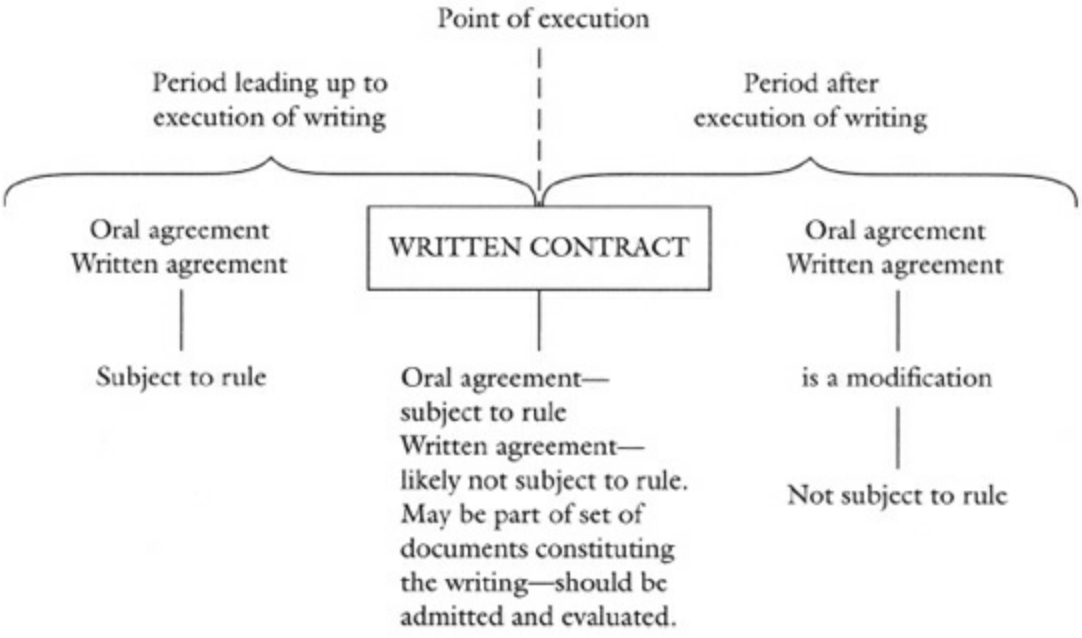
relevance to an agreement entered into subsequent to the writing. This is in fact a modification, which is subject to its own particular rules but it is not affected by the parol evidence rule.[1]

It is usually easy to tell if an oral agreement was made after the writing because they are separated by some distance in time. However, in some situations it may not be clear if the oral agreement is contemporaneous with or subsequent to the writing. For example, in *Kehr Packages, Inc. v. Fidelity Bank*, 710 A.2d 1169 (Pa. 1998), the bank had agreed to finance the purchase of shares in a corporation. The closing of the transaction took all day. The parties signed a written loan agreement during the course of the day. After the agreement was signed, but before the closing was over, the borrowers asked the lender to increase the amount of the loan. The borrowers claimed that the lender agreed to this increase orally, but the written agreement was not changed to reflect this. The trial court admitted evidence of the oral agreement on the basis that it was subsequent to the writing and not subject to the parol evidence rule. The supreme court reversed and held that the evidence was barred by the rule. The closing was a single, continuous transaction and it was artificial to focus on the exact sequence of the signing and the alleged oral agreement. The crucial point is whether they are both within the same process of formation, and if they are, the parties (especially sophisticated parties, as in this case) should ensure that the writing is changed to include any oral understandings. Because the court found the oral agreement to be contemporaneous and irreconcilable with the writing, evidence of it was excluded.

§12.3.5 Summary of the Scope of the Parol Evidence Rule

Diagram 12A summarizes the range of the parol evidence rule as discussed in the preceding subsections.

Diagram 12A



§12.4 A CLOSER LOOK AT THE PURPOSE AND PREMISE OF THE PAROL EVIDENCE RULE

The primary purpose of the parol evidence rule is to control the jury's decision making. It allows the judge to restrict the information given to the jury, thereby shielding it from evidence the judge finds to be suspect and unreliable. A secondary justification for the rule is that it promotes efficiency in the conduct of litigation. By excluding suspect evidence at the outset (often at the stage of a motion for summary judgment or dismissal), the judge saves the time that would otherwise be wasted in presenting the evidence to the jury and cross-examining the witnesses. Finally, the existence of the rule may help promote transactional efficiency. Because it exists, parties are more likely to make an effort to record their agreement fully and accurately.

Although the parol evidence rule leads to the exclusion of evidence of the parol agreement, it is characterized as a rule of substantive contract law, not a rule of evidence. In essence, the substantive rule nullifies the offending parol agreement, so that evidence of it becomes inadmissible as irrelevant. For most purposes, this distinction makes no practical difference, and the rule operates largely in the same way as a rule of evidence.[2]

The basic concept of the parol evidence rule is quite simple and its premise is grounded in common sense. Sadly, however, this basic simplicity is completely overwhelmed by the considerable difficulties that emerge when one tries to define the scope of the rule and to apply it to inconclusive facts. The complexity and confusion generated by the rule result largely from the dilemma it presents to courts: The rule serves a useful role in permitting the exclusion of evidence that is probably unreliable or dishonest, but it also has the potential of producing injustice by preventing a party from proving what was actually agreed. A firm rule is more efficient at keeping out undesirable evidence but is also more likely to exclude legitimate evidence. A more flexible rule allows the court greater discretion in evaluating and determining the reliability of evidence, but it weakens the protection against undesirable evidence and detracts from the certainty and clarity of the law. If you think of the rule as a door to the witness box, its ideal design would keep out the perjurer and irrelevant waffler but would admit the honest and pertinent witness. The current state of the rule aspires to that design but has not achieved it and probably cannot.

The following illustration indicates the premise of the rule: The Four Crooners is a popular troupe of tenors who sing light opera and ballads. The Four Crooners entered into a written recording contract with Integrated Recording Co., Inc. The contract provided that Integrated Recording would produce and distribute a CD of the Four Crooners' music. The Four Crooners would receive a royalty of 15 percent of gross receipts from sales of the CD. The CD was made, and 150,000 copies were sold in the first month. This resulted in a dispute between the parties and a suit by the Four Crooners for larger royalties. As the basis of the suit, the Four Crooners claim that before they signed the written contract they told Integrated Recording that they were willing to accept a 15 percent royalty on the first 100,000 CDs sold, but if sales exceeded that volume, they wanted a royalty of 18 percent on all sales beyond 100,000 copies. They allege that Integrated Recording agreed to this orally. This change does not appear in the written contract and Integrated Recording denies agreeing to it.

Because the written contract does not mention this alleged term, the Four Crooners have no case unless they are allowed to testify to the oral promise. The rule of law could simply be to admit the evidence of both parties and to leave it to the factfinder (usually the jury) to decide if such an oral agreement was reached. However, the common law has not taken this

approach. Instead, it has developed the parol evidence rule, which acts as a gatekeeper by allowing the judge to determine if the jury should be allowed to hear the evidence of the oral agreement.

How is the court likely to react to the Four Crooners' attempt to testify to the alleged oral term? It is quite easy to see why the parol evidence rule might be useful in a case like this. The parties went to the trouble of recording their contract in writing and the royalty provision seems definitive and clear. Surely, had the parties agreed to an 18 percent royalty on sales over 100,000 copies, this would have been in the writing. The absence of the term in the writing suggests either that the Four Crooners are mistaken in thinking that Integrated Recording agreed to it, or they were very sloppy in not making sure that the writing reflected what was actually agreed, or worse, they are making it up. Whatever the reason, the testimony is suspect and maybe it is best that the jury never gets to hear it. Because the Four Crooners' case is entirely based on the alleged oral term, the lawsuit can be dismissed summarily.

Say that the facts of the dispute were different. The written contract is as stated above, but the Four Crooners do not claim an agreement for increased royalties. Instead, they claim that Integrated Recording made an oral promise at the time of signing the contract that it would arrange a ten-city concert tour to promote the CD. It failed to do this and denies agreeing to it. The written agreement is completely silent on the question of promotional tours and concerts. If the parol evidence rule simply barred all testimony of oral agreement, it would be too blunt an instrument. Therefore, the rule is more nuanced. As this testimony does not directly contradict the writing, it may be less presumptively suspect and there may be a greater justification for admitting it. In the following sections we will explore these nuances. Before we look at the rule more closely, it is useful to articulate some of the features of the rule that have been suggested by the preceding discussion:

1. The rule only applies when a written agreement has been executed. The rule applies whether the writing is a comprehensive or incomplete record of the agreement. However, the more complete the written memorandum, the more rigorous the application of the rule.
2. The writing must have been adopted by both parties. It need not be signed by them as long as it is shown to be a mutual document. Naturally, the presence of signatures more strongly proves that it is a

joint memorandum, but a letter written by one party and received by the other without objection qualifies. A memorandum written by only one of the parties and not disseminated to the other does not bring the rule into effect. To invoke the parol evidence rule, a writing must therefore have qualities beyond those needed to satisfy the statute of frauds. This is because the statute is concerned with the minimal amount of writing needed to establish the existence of a contract, while the parol evidence rule is concerned with the degree to which the writing should be used to exclude extrinsic evidence of what was agreed.

3. Remember that the word “parol” suggests that the rule is primarily concerned with oral communications between the parties before or at the time of execution of the writing. However, the rule is not confined to oral communications, and it also covers prior written communications.
4. The rule does not absolutely bar all parol evidence. If it did, our job would be much easier, but the results of the rule would be bizarre. The purpose of the rule is to exclude presumptively irrelevant or concocted testimony, but not honest and pertinent evidence of what was actually agreed. The rule must therefore be sufficiently fine-tuned to allow the court to make this distinction. Herein lies the greatest complexity and difficulty in devising and applying a rational rule.
5. The rule contemplates a two-stage process. When the parol evidence is proffered, the judge must make an initial finding of admissibility. If the judge finds that the evidence is admissible, it is presented to the factfinder (the jury unless the trial is before a judge alone) that hears the testimony and makes the ultimate finding on credibility. The judge’s initial determination is characterized as a question of law, but it is not necessarily devoid of factual evaluation. This is one of the confusing aspects of the rule. Although the factfinder may eventually have to decide if the evidence is believable, the judge, in making the initial decision on admissibility, is also concerned with the plausibility of the proffered evidence, a preliminary issue of credibility. It should be noted that this two-stage process is very common where a judge has to decide the admissibility of evidence for reasons unrelated to the parol evidence rule. Because the jury must not hear inadmissible evidence, the judge invariably has to conduct a

hearing outside the presence of the jury to decide if the evidence should be admitted. This reinforces the point made above that the parol evidence rule really does operate as a rule of evidence for most purposes, even though its characterization as a rule of substantive law has some legal consequences.

§12.5 THE DEGREE OF FINALITY OF THE WRITING: TOTAL AND PARTIAL INTEGRATION

The impact of the parol evidence rule depends on the degree to which the writing executed by the parties constitutes a comprehensive and final memorandum of their agreement. In short, if the writing is full, complete, unambiguous, and clear, the rule excludes all parol evidence. But to the extent that the memorandum does not fully and unequivocally cover all of the agreed terms, parol evidence is admissible to supplement it. Even here, however, the parol evidence cannot contradict what has been written or add to those aspects of the agreement that have been fully dealt with in the writing. As discussed in section 12.6, it can be a difficult question of interpretation to determine whether and to what extent the memorandum is comprehensive and final.

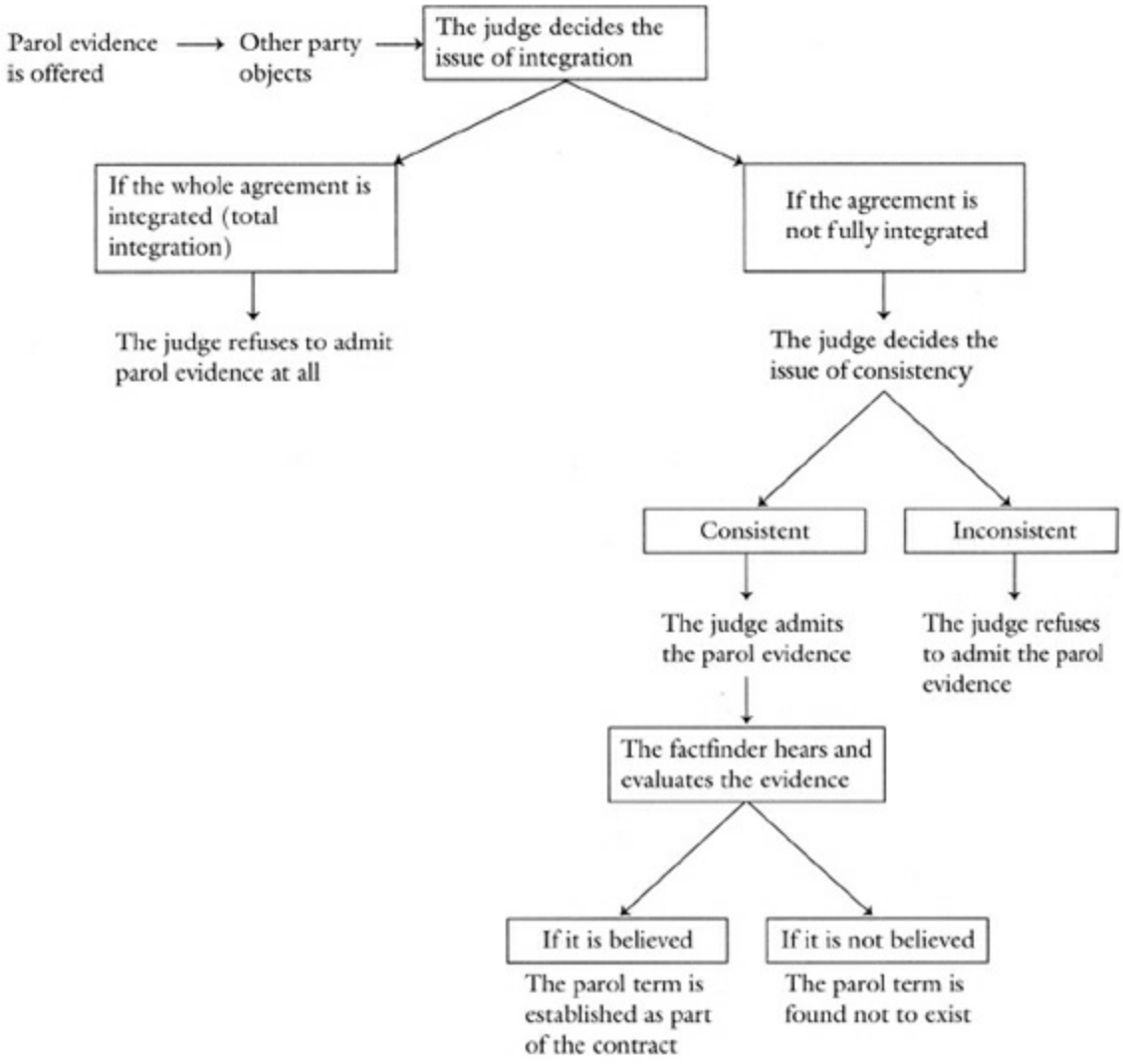
If the memorandum is a complete, final, and certain record of the parties' agreement (that is, it unambiguously and clearly expresses every term in the agreement, and it is intended to be the exclusive statement of everything that was agreed), it is said to be totally or completely integrated. If the writing is truly a total integration, then, by definition, no terms can exist beyond those set out in the writing. It follows that neither party should be allowed to offer parol evidence tending to prove terms extrinsic to the writing, because such evidence is irrelevant or incredible.

If the writing is not a complete and final record of the agreement, it is said to be partially integrated or unintegrated. The written agreement may fully and finally express some but not all of the terms, or it may not fully and finally express any term. If so, the parol evidence rule permits parol evidence to be admitted to supplement or explain the writing to the extent that it is not integrated. However, the parol evidence must be consistent with, and cannot contradict or vary terms that have been recorded in the writing.

§12.6 THE PROCESS OF DEALING WITH PAROL EVIDENCE

The issue of the admissibility of parol evidence could arise early in the suit if one of the parties applies for summary judgment or dismissal in response to a claim or defense based on an alleged parol term. Because the admissibility of parol evidence is a legal question, a dispute on admissibility is often appropriate for summary adjudication. If the case is not disposed of on the pleadings and it goes to trial, the admissibility of the evidence may be challenged when an attempt is made to introduce it. As noted before, the evaluation of parol evidence involves two stages. In the first, the judge decides admissibility as a legal matter. If the evidence is admitted, the factfinder evaluates its credibility. We now look more closely at the process involved in each of these two stages, which may be charted as shown in Diagram 12B.

Diagram 12B



Stage 1: The judge's determination

In making the finding of admissibility, the judge conducts an inquiry that may itself be split into two sequential components:

1. Logically, the first issue to be resolved by the judge is the question of integration. Is the writing a full and final record of the agreement as a whole (that is, a complete integration)? If so, we do not get beyond the first inquiry, because the parol evidence may not be admitted.
2. If the writing is not a complete integration, consistent supplementary parol evidence is admissible. The judge's inquiry then turns to whether the proffered parol evidence is in fact consistent with and not contradictory to what has been written. If it contradicts the writing, it

may not be admitted, and it still never reaches the jury.

Having drawn this distinction between the judge's two inquiries, it is useful to express a word of caution: It is easy enough to separate the issue of integration from the issue of consistency for the purpose of theoretical analysis, and it is logical that the first must be resolved before the second is reached. However, as a practical matter, the inquiry into integration is often influenced by the question of whether the alleged parol term is consistent with the writing, and these two stages often meld into one another. That is, unless the intent to integrate is so clear that there can be no doubt on the matter, the extent to which the alleged parol term is reconcilable with the writing may affect the court's decision on whether an integration was reasonably intended by the parties. Therefore, you will see cases in which the court does not neatly proceed in the sequence that is charted here.

Stage 2: The factfinder's determination

If the judge's preliminary inquiry into the evidence leads to the determination that the subject matter covered by the alleged term has not been integrated into the writing and that the proffered parol evidence is consistent with what has been written, the judge rules the evidence admissible. It may then be presented to the factfinder, which is responsible for the ultimate decision on whether the term was agreed to. If the case is to be tried by a jury, the dichotomy between judge and factfinder is clear. However, if the parties have agreed not to try the case before a jury, the judge is the factfinder, and the dichotomy becomes quite artificial. The judge, in the role of legal arbiter, makes the initial finding as a matter of law. If she rules the evidence inadmissible, she must then exercise the professional objectivity of not being influenced by it in her role as factfinder. This is probably not as difficult as it sounds—the fact that the judge excluded it as a matter of law means that she could not have found it very convincing to begin with—as explained further below.

§12.7 DETERMINING THE QUESTION OF INTEGRATION

The determination of admissibility of evidence is the judge's function, so in

the context of the parol evidence rule, intent to integrate is treated as a question of law. To decide if the parties intended the writing to be a full and final expression of their agreement, the court must interpret it. During the classical period of contract law, courts tended to emphasize the objective test of assent and to place great importance on the reasonable meaning of language. This heavy emphasis on objectivity made the question of determining integration relatively easy: If the writing, interpreted as a whole in accordance with the plain meaning of the language used, appeared to be a full and final expression of the agreement, it was deemed to be integrated. Thus, the judge decided the parties' intent to integrate their agreement in the writing purely on the basis of the "four corners" of the written document, without recourse to any extrinsic evidence. If the document appeared complete this intent was established and no parol evidence was admissible to add to or alter its reasonable meaning.

Many modern courts recognize that a strict and invariable "four corners" approach may disregard contextual evidence that is helpful in deciding intent to integrate. They realize that even when a writing appears at face value to be comprehensive, inquiry into the context in which it was written may dispel this impression. Therefore, in deciding the question of integration, a contemporary court may go beyond the face value of the writing to reach a decision on whether the parties intended an integration. As explained below, this does not mean that courts will always consider extrinsic evidence in deciding integration. Some courts are more open than others to going beyond the four corners of the document. Even courts that are generally receptive to extrinsic evidence may refuse to consider it where the intent to integrate is strongly expressed in the writing, particularly where the writing contains a merger clause that expresses the intent to integrate.[3] If the court does consider extrinsic evidence, the judge's evaluation of that evidence is preliminary. If the judge concludes that the evidence is admissible as a matter of law, the factfinder (whether a jury or the judge herself in that role) will be the final arbiter of its factual truth.

When an apparently integrated agreement does not contain the term that was allegedly agreed to, one of the key questions in determining integration under the contextual approach is to ask whether the circumstances offer an explanation of why the term may not have been included in the writing. Restatement, Second, §216(2)(b) expresses this concept by asking whether the term is such as "might naturally be omitted" from the writing. UCC

§2.202, Comment 3, suggests a similar inquiry: Would the term "certainly have been included" in the document had it been agreed to? The UCC test sounds more favorable to admission because it excludes the evidence only if it clearly would have been part of the writing if the parties had agreed to it. However, in most cases, this test would not likely give a different result than the Restatement's inquiry into whether the term might naturally have been agreed separately.

It is worth stressing the caution mentioned above: Even under a contextual approach, courts pay particular attention to the scope and language of the writing. Where the writing is clear, unambiguous, and apparently complete, proffered extrinsic evidence would have to be very plausible to overcome the conclusion that the writing itself demonstrates an intent to integrate. The extrinsic evidence must both be reconcilable with the apparent intent and demonstrate a justification for going beyond the writing. It is therefore still common to find that courts rely very heavily on the "four corners" of the writing in deciding integration.

Masterson v. Sine, 436 P.2d 561 (Cal. 1968), is one of the best-known cases to apply a contextual approach and to inquire whether a term absent from the agreement might naturally be omitted from the writing. Masterson and his wife sold a ranch to the Sines, his sister and her husband. The written contract granted the Mastersons an option to repurchase the ranch at a price to be fixed by a formula. Masterson later became bankrupt and his trustee attempted to exercise the repurchase option to bring the property into Masterson's estate for the benefit of his creditors. The Sines claimed that the trustee could not exercise the option because the parties had orally agreed at the time of the sale that the option was personal to the Mastersons and could not be transferred to or exercised by anyone else. The majority found that such an agreement might naturally be made outside the written contract in a family transaction. The dissent disagreed with the majority's approach and resolution. It found the writing to be integrated on its face and criticized the "might naturally be omitted" test as too uncertain and open-ended. Even if that test was appropriate, the dissent did not find that this oral term would have satisfied it. A restriction on transfer of the option would not naturally be excluded from the writing if the parties had agreed to it. The option itself was granted in the writing, so surely any restriction on its exercise would be set out there too had the parties agreed to it. The dissent also commented on the credibility of the Sines' assertion: it was particularly suspicious because it

was aimed at keeping the property out of Masterson's bankruptcy estate.

Myskina v. Conde Nast Publications, Inc., 386 F. Supp. 2d 409 (S.D.N.Y. 2005), is a good contrast to *Masterson*. Myskina, a Russian tennis champion, agreed with Conde Nast to pose nude for photographs to be published in a "sports" issue of *GQ* magazine. Immediately before the photographs were taken, Myskina signed a written release in which she irrevocably and unqualifiedly consented to the use of the photographs by Conde Nast. The first photos taken during the photo shoot portrayed Myskina as Lady Godiva. She was not entirely nude in these photos, but wore flesh-colored pants and, had long hair covering her breasts. The photos taken after that were more revealing. Myskina alleged that she had expressed discomfort over posing for them but the photographer assured her that only the Lady Godiva photos would be published.[4] *GQ* magazine published the Lady Godiva photos. The photographer subsequently sold the nude photos, which were published in another magazine. Myskina sued Conde Nast and the photographer for damages and an injunction on the grounds that the nude photos were published without her authorization. Her suit did not survive summary judgment. She sought to testify to the oral undertaking to publish only the Lady Godiva photos, but the court refused to admit that evidence. The court found that the release, interpreted in its plain meaning within the context of the transaction, was an integrated document that clearly and comprehensively expressed unrestricted consent to publication. The alleged oral term imposed a fundamental condition on that consent that would not have been omitted from the writing had it been agreed to by the parties.

It is common to find a provision in a written contract to the effect that the written contract is the entire agreement between the parties, and that no representations or promises have been made save for those set out in the writing. This is called a merger clause because it signifies that all the terms of the agreement have been merged into the writing. Where the written contract appears to be complete, the inclusion of a merger clause is strong evidence of integration. As a result, a merger clause can be effective in disposing of the issue of integration and insulating the writing from parol evidence. However, a merger clause is not always conclusive. Sometimes courts will go behind a merger clause and admit parol evidence, where, under all the circumstances of the transaction, one of the parties makes a plausible argument that, despite appearances, the writing is not really integrated, and the alleged parol term can be reconciled with it. A court may be more amenable to such an

argument where the merger clause is a standard term in a form contract.

To illustrate some of the difficulties in deciding the question of integration, let us return to the example of the recording contract between the Four Crooners and Integrated Recordings, introduced in section 12.4. Assume that the parties' agreement is recorded in a written contract, five pages long. The contract specifies the songs to be recorded, the date of recording, the date of release, and the royalty of 15 percent to be paid on gross receipts. It has numerous provisions setting out the duties of the Four Crooners in the production of the recording as well as detailed provisions relating to the distribution of the CD and the accounting for and payment of royalties. It ends with a merger clause. The writing appears to be full and comprehensive. Consider the two alternative allegations of parol agreement made by the Four Crooners. One was that the parties agreed orally to a royalty of 18 percent on sales over 100,000 copies. The other was that Integrated Recording undertook to arrange a ten-city concert tour to promote the CD. On a strict "four corners" approach, the writing is unquestionably integrated, and no evidence would be admitted of either of these alleged parol terms. The Four Crooners are not likely to do any better on a contextual approach. The written contract specifies the royalty percentage, so it is not natural that the parties might agree to part of that term separately. It is hard to reconcile the parol augmentation of the royalty term with the unequivocal written term. The term relating to the concert tour is not as badly at odds with the writing, but it does not seem natural that this single term would have been omitted from an otherwise detailed written agreement. In addition, the only contextual evidence tendered is the disputed, self-serving testimony of the Four Crooners themselves about what was said at the time that the writing was signed. (As you can see, credibility issues cannot be entirely divorced from this legal inquiry, and the issues of integration and consistency, while doctrinally distinct, often intermingle in the decision on integration.)

However, say that the written contract was not as detailed as described above. It is a simple, one-page document that sets out the songs to be recorded, the date of recording, the date of release, and the royalty of 15 percent to be paid on gross receipts. It has none of the detailed provisions relating to the parties' performance set out above and no merger clause. Parol evidence on the increase in royalties is still not likely to be admissible because the royalty clause appears to be definitive and not easily reconcilable with the alleged parol agreement. However, evidence of the undertaking of a

concert tour stands a better chance of admission. The absence of details about the obligations of the parties in performing the contract and the lack of a merger clause could make it more natural that an agreement about a promotional tour might be made separately from the writing.

§12.8 AMBIGUITY OR INDEFINITENESS IN AN INTEGRATED WRITING

The discussion of integration up to now has assumed that the terms of the writing are clear and unambiguous. Where that is not so, a further complication arises: no matter how firmly the parties may have intended the writing to be a full and final expression of their agreement, if a term of the writing is unclear or ambiguous, the writing cannot be treated as an integration of that term. If extrinsic evidence is available to clarify the indefiniteness, that is the best means of ascertaining the parties' intended meaning. Parol evidence is therefore admissible to clarify the uncertainty or ambiguity. This does not mean that uncertainty or ambiguity allows for the admission of whatever parol evidence may be tendered on any aspect of the contract. The evidence must be pertinent to the meaning of the unclear term, and it must be reconcilable with what has been written.

As we see in the discussion of interpretation in Chapter 10, many courts have moved away from a purely text-based approach to the question of whether a term is uncertain or ambiguous, and are receptive to available contextual evidence that casts light on the meaning of the written language. Even if the writing seems clear and unambiguous on its face, the contextual approach assumes that written words do not have a constant, immutable meaning, but that the context in which the words were used could color their meaning.

For example, recall that the written contract between the Four Crooners and Integrated Recording provided that the Four Crooners would receive a royalty of "15 percent of gross receipts from CD sales." Say that the Four Crooners do not make any allegation that the parties agreed to a higher royalty for sales over 100,000 copies. Rather, the dispute centers on the meaning of "gross receipts from CD sales." The Four Crooners say that the phrase is intended to include all income derived from sales of the recording,

whether in the form of actual physical CDs, or in intangible forms, such as music files that are downloaded from Web sites. Integrated Recording argues that the clear language of the written contract intends to confine the royalties to receipts from CD sales. The Four Crooners seek to testify that this point was discussed by the parties at the time of signing the contract, and they orally agreed that "gross receipts from CD sales" meant all income from sales of the recording in any form. A literal-minded court applying a four corners approach may consider the written language to be clear in confining royalties to receipts from CD sales. However, a court that sees context as important is likely to be less confident of the face-value meaning of the writing. Provided that the written language is reasonably susceptible of the meaning alleged by the Four Crooners, it would consider this evidence as a preliminary matter to decide the question of whether the writing is unclear. The court may ultimately decide that it is not. The point, though, is that the court would be reluctant to exclude the parol evidence without having the opportunity to think about the word's meaning in light of it. (It is also worth stressing again that even if the court decided to admit the evidence, the Four Crooners must still persuade the jury that the oral agreement was made.)

§12.9 DISTINGUISHING CONSISTENCY FROM CONTRADICTION

If the judge decides that the writing is a full and final expression of the parties' agreement (that is, it is totally integrated) the inquiry ends and the parol evidence is excluded. However, if the judge determines that the writing is not totally integrated, parol evidence is admissible to supplement or explain the writing, but not to contradict it. Stated differently, even where the agreement is not fully integrated, parol evidence cannot be admitted if it is inconsistent with, and cannot be reconciled with, what has been written.

It may be obvious that an alleged parol agreement contradicts the writing. For example, if a contract for the sale of a house states that the price is $500,000, evidence of a contemporaneous oral agreement that the parties agreed to a price of $475,000 cannot be reconciled with the writing. A second example of inconsistency is the illustration in section 12.7 involving the Four Crooners' proffered testimony that the parties had agreed to an 18 percent

royalty on sales over 100,000 copies. It is very hard to reconcile this with the clear term in the written contract that provides for a 15 percent royalty on gross receipts. However, in some cases, the possible inconsistency is less clear and may be trickier to decide. Both *Masterson* and *Myskina*, discussed in section 12.7, involved a more subtle question of contradiction. The alleged parol term did not directly clash with a written term, but it departed from the normal legal or factual implications of the language. That is, there was no language in the written contract in *Masterson* stating that the option was assignable, and there was no language in the release in *Myskina* that expressly authorized the publication of the nude photos. However, the absence of any stated limitations on transfer or on authority to publish created the implied understanding that they did not exist.

Maday v. Grathwohl, 805 N.W.2d 285 (Minn. App. 2011), provides another example of a nuanced contradiction. The Grathwohls, owners of a pig farm, needed a means of disposing of the manure generated by their pigs. They therefore entered into a written "manure easement agreement" with Maday, the owner of neighboring farmland, under which they had the right to apply manure generated on their farm on Maday's farmland. The written agreement made it clear that this arrangement was mutually beneficial to the parties—the Grathwohls would be able to get rid of their manure, and Maday would get manure to fertilize his land. The agreement did not require any other compensation to be paid by either party. The agreement also contained no language suggesting that the Grathwohls were obligated to provide manure to Maday, and it specifically stated that they made no warranty as to the quantity or quality of the manure. For several years after this contract was executed, all the manure from the Grathwohls' farm was applied to Maday's land. However, about seven years after the agreement was made, the Grathwohls began to sell some of the manure to third parties, thereby reducing the amount available for fertilizing Maday's land. Maday sued, claiming that by selling the manure, the Grathwohls had breached an oral agreement, made when the easement was granted, under which they had promised that Maday would receive all the manure generated by the pig farm. The trial court refused to admit this evidence of the alleged oral agreement and granted summary judgment to the Grathwohls. On appeal, Maday argued that the evidence should have been admitted because the oral agreement was separate from and consistent with the written easement. The court of appeals disagreed and affirmed the trial court's grant of summary judgment. It found

that the written contract gave the Grathwohls the right, but not the duty, to spread the manure on Maday's land, and there was no provision in the contract that transferred ownership in the manure. Therefore, the court held that because the alleged oral agreement covered the same subject matter as the written agreement (the manure), and was part of the same transaction, it would not naturally be made as a separate agreement. In addition, the alleged oral term was inconsistent with the written agreement, which did not appear to contemplate that the Grathwohls made any commitment to give Maday manure.[5]

Courts do not approach the issue of conflict with implied terms uniformly. A judge who is not enthusiastic about barring parol evidence will likely be reluctant to find a conflict unless there is a very clear and express inconsistency between the writing and the parol evidence. A judge who is more favorably disposed to excluding parol evidence is likely to be more willing to find a conflict between the proffered parol evidence and a term that is implied into, but not expressly articulated, in the writing. Therefore, bear in mind that conflict may go beyond an obvious clash with an express term and may arise where the alleged parol term cannot be reconciled with the legal import of the writing.

Before leaving the subject of contradiction, it is worth restating that although it is possible, as a doctrinal matter, to separate the inquiry into integration from the question of consistency, the cases show that in practice these two concepts are often interrelated. That is, if the court considers the parol term to be at odds with the writing, this factor may influence the court in deciding whether the writing is integrated. In fact, Restatement, Second's "might naturally be omitted" test and Article 2's "would certainly have been included" test speak as much to consistency as they do to finality of the writing. These two inquiries melded into each other in both the *Masterson* and *Myskina* cases. In *Masterson* the majority's conclusion that the limitation on the option might naturally be made as a separate agreement was motivated in part by its perception that the limitation did not directly contradict any express language in the written grant of the option. The dissent saw the limitation as contradictory because the usual implication of law is that an option is transferable unless the agreement clearly states otherwise. In *Myskina*, the court's conclusion that the release was integrated was based in its view that the limitation on the release would certainly have been included in the writing had the parties agreed to it. The court went on to say that, in

any event, a parol term qualifying the extent of the release was inconsistent with the absolute release in the writing.

§12.10 THE EFFECT OF THE RULE ON EVIDENCE OF COURSE OF PERFORMANCE, COURSE OF DEALING, AND TRADE USAGE

In dealing with interpretation in context, section 10.1.3 explained the meaning of and the role played by course of performance, course of dealing, and trade usage. We now focus on what impact the parol evidence rule might have on the admissibility of this type of contextual evidence. In most cases course of performance can be disposed of easily because it is typically not parol evidence. Although it is conceivable that there could be a course of performance between the oral agreement and the execution of the writing, in most situations any course of performance only takes place after the written contract has been executed. However, course of dealing is, by definition, something that occurs prior to the contract and trade usage exists prior and contemporaneously with it. Therefore, a court could treat evidence of course of dealing or trade usage as a form of parol evidence and could exclude it if the agreement is integrated or, even if not, if it cannot be reconciled with the written terms. However, course of dealing and trade usage differ in an important respect from the evidence of a party on the discussions that led to the alleged parol agreement—a course of dealing or trade usage can be established by more reliable objective evidence of mutual conduct or accepted custom. Courts are therefore more likely to admit evidence of course of dealing and trade usage.

Restatement, Second, §213 provides no guidance on how a court should approach this kind of contextual evidence. It refers only to parol terms that were allegedly agreed to between the parties during their interaction leading up to the execution of the writing. By contrast, UCC §2.202(a) specifically permits an otherwise integrated agreement to be supplemented by evidence of course of dealing and trade usage. (Section 2.202(a) also specifically includes evidence of course of performance which, as noted above, typically does not even qualify as parol evidence.)

Where the written memorial of the contract is not a full and complete

expression of the terms of the contract, it is easy to see why a court would be receptive to course of dealing or trade usage evidence to supplement or explain the contract's terms. For example, *Grace Label, Inc. v. Kliff*, 355 F. Supp. 2d 965 (S.D. Iowa 2005), involved a contract to supply trading cards bearing the likeness of Britney Spears, to be placed in packets of snack food. Sadly (and I am sure this is no reflection on Britney) the cards smelled bad and were unfit for inclusion in food packages. The seller sought to admit evidence of a course of dealing to establish that it had not breached the contract by supplying smelly cards. The seller offered this evidence of prior transactions to establish the parties' expectation that the seller would use the same materials in printing the cards as it had used in similar prior transactions. The seller had done so, and therefore argued that it was not responsible for the problem with the cards. The court overruled the buyer's objection to the admission of this evidence, which it held merely explained and supplemented, but did not contradict the written contract term.

However, UCC §2.202 goes beyond merely allowing evidence of course of dealing, trade usage or course of performance where the agreement is not integrated. It makes it clear that this type of contextual evidence should be admitted even where the writing is intended as a final expression of agreement.[6] That is, §2.202 presumes very strongly that the parties intend to contract in light of their own and the market's customary practices. This means that the parties could reasonably take for granted that the contract includes terms arising from these sources, and may not mention them in the writing, even where that writing is otherwise fully integrated. This strong recognition of course of dealing and trade usage compels parties to use very clear and specific language in the writing if they truly do intend to exclude a course of dealing or a trade usage from their contract.

The strength of trade usage and the likelihood that it will be found consistent with the writing in all but the most overwhelming cases of direct conflict is illustrated by *Nanakuli Paving & Rock Co. v. Shell Oil Co.*, 664 F.2d 772 (9th Cir. 1981). We first encountered this case in section 10.1.3 in connection with the role of trade usage in interpretation. Recall that the written contract under which Shell supplied asphalt to Nanakuli provided that the price of the asphalt was Shell's posted price at the time of delivery. The court held that this clear language was qualified by a trade usage under which the seller would "price protect" the buyer by charging the lower posted price prevailing at the time that the buyer committed itself under a paving contract

with its customer. Because the contract was in writing, the court had to decide whether the evidence of trade usage was admissible. Although the price term was clear and seemed quite absolute, the court found no inconsistency between the price term and the price protection usage. *Nanakuli* may go further than other courts in its notion of consistency, but it does show that, at least where a sale of goods is involved, parties should not lightly assume that trade usage or course of dealing evidence will be barred by an apparently integrated writing that does not specifically negate the usage or course of dealing.

§12.11 THE COLLATERAL AGREEMENT RULE

The collateral agreement rule is sometimes referred to as an exception to the parol evidence rule, but it is not really an exception at all. Rather, it follows from an application of the general principles of the parol evidence rule. The collateral agreement rule developed as a means of softening a firm "four corners" approach to parol evidence at a time when courts were more inclined to determine integration by looking no further than the four corners of the writing. A court that adopts a broader contextual approach to parol evidence and uses the Restatement, Second's "might naturally be omitted" test or Article 2's "would certainly have been included" test does not need the collateral agreement rule because those tests cover the same type of situation and are less rigorous. However, the rule still features in some modern cases.

The gist of the rule is that even where a contract is integrated, if the parol agreement is sufficiently distinct from the scope of the writing, it can be seen as a different contract, related to but separate from the integrated written agreement. If so, evidence of this collateral agreement is not barred by the parol evidence rule. Stated differently, even if the alleged parol agreement relates to the same transaction as the writing, if it is self-contained and distinct enough to be seen as a collateral agreement, the parties may not have intended it to be covered by the integrated writing. Evidence of the collateral agreement may therefore be admitted. The requirement of consistency applies even where the parol agreement is found to be collateral, so evidence of a collateral agreement that contradicts the writing may not be admitted. The determination of whether an agreement is collateral can be slippery, and

different courts have different views on the relationship between the writing and the parol agreement. A requirement that is regularly expressed is that both the subject matter of and the consideration for the parol agreement must be distinct and capable of being separately identified.

Mitchell v. Lath, 160 N.E. 646 (N.Y. 1928), is one of the best-known cases to deal with the collateral agreement rule. The seller of real property agreed orally to remove an unsightly ice house on land adjacent to the property sold to the buyer. This undertaking was not included in the written contract for the sale of the property. The written contract appeared comprehensive and included a number of other terms ancillary to the sale. The majority of the court refused to find that the agreement to remove the ice house was a collateral agreement—it was related closely enough to the sale of the property that one would expect to find it in the writing if it had been agreed to. The dissent felt that the oral undertaking was distinct enough that the parties could have made it as a separate ancillary contract, not intended to be integrated into the writing.

The collateral agreement rule was also considered in *Myskina v. Conde Nast Publications, Inc.*, discussed in sections 12.7. and 12.9. The court held that the oral agreement limiting the magazine's right to publish the nude photos was not collateral to, but an integral part of the release, and that it contradicted it. The close conceptual connection between the collateral agreement rule and the Restatement, Second, and UCC tests should be apparent from the account of these cases. It is even more striking in *Maday v. Grathwohl*, the case involving the manure easement agreement, also discussed in section 12.7. The court does not mention the collateral agreement rule and discusses consistency on the basis of a test equivalent to the Restatement, Second's "might naturally be omitted" test. However, in discussing the admissibility of the evidence that the Grathwohls made an oral commitment to give all the manure to Maday, the court focused on factors associated with the collateral agreement rule: The agreements addressed the same subject matter and had the same consideration.

§12.12 EXCEPTIONS TO THE PAROL EVIDENCE RULE: EVIDENCE TO ESTABLISH GROUNDS FOR AVOIDANCE OR INVALIDITY OR TO SHOW A CONDITION

PRECEDENT

§12.12.1 The Exception Relating to the Validity or Voidability of the Contract

The primary purpose of the parol evidence rule is to keep spurious or irrelevant evidence from the factfinder, but there is always a danger that it may be used to exclude truthful evidence of genuine agreement that was, for some reason, not encompassed within the writing. If the parol evidence relates to an alleged term that was in fact agreed to but is not reflected in a completely integrated writing or is not consistent with what was written, the party seeking to present the evidence is out of luck. By failing to ensure the accuracy of the writing, that party exposed itself to the risk of not being able to prove the term.

However, in some situations, this result may be too harsh, and may play into the hands of an unscrupulous operator who has deliberately taken advantage of the other party. To cater to such situations, there is a well-recognized exception to the rule that permits the introduction of parol evidence to show fraud, duress, illegality, mistake, and other bases for invalidating or avoiding the contract. The rationale for this exception is explained in *Riversisland Cold Storage, Inc. v. Fresno-Madera Production Credit Assn.*, 291 P.3d 316 (Cal. 2013): The parol evidence rule is meant to protect the terms of a valid recorded contract but should not bar evidence that goes to the very validity of the agreement.

In the case of fraud or other wrongdoing, the additional rationale is that a party should not be able to use the rule to mask the fraud or other wrongful conduct. *Riversisland* stated the well-accepted principle that the fraud exception applies, even if the parol evidence contradicts the written agreement. The court took the same approach in *Golden Eye Resources, LLC v. Ganske*, 853 N.W.2d 544 (N.D. 2014), holding that contradictory parol evidence is admissible where the evidence related to fraudulent misrepresentations made to induce the contract.

A court may allow the fraud exception even where the victim of the fraud specifically affirms in the written contract that it has not relied on any misrepresentations made outside the writing. For example, in *America's Directories, Inc. v. Stellhorn One Hour Photo, Inc.*, 833 N.E.2d 1059 (Ind. App. 2005), the president of America's Directories, a corporation that sold

advertising in a telephone directory, used persistent hard-selling techniques to persuade Stellhorn to sign three standard form contracts under which it purchased three years' advertising in the directory. Stellhorn was reluctant to buy the ads, and only did so after being assured orally that he could cancel after one year. The standard form contracts stated unequivocally that they could not be canceled, and they contained a merger clause excluding all verbal agreements and representations not contained in the writing. Despite that, the court admitted evidence of the oral agreement because the evidence indicated that America's Directories never intended to allow Stellhorn to cancel and it made several other false representations to induce him to enter the contracts.[7]

Of course, the admission of the evidence is not the final word on the matter. Even if the evidence is admitted, the victim of the alleged fraud must still prove that all the elements of fraud are satisfied. We deal with the elements of fraud more fully in section 13.6. For the present, it is enough to note that relief is available for fraud if a party makes a fraudulent misrepresentation that justifiably induces the victim to enter the contract. In some circumstances a party who succeeds in having the parol evidence admitted under the fraud exception to the parol evidence rule could later have a problem convincing the factfinder that his reliance on the misrepresentation was justifiable. A party who executes a writing that omits a material representation may be held not to have been justified in relying on a representation that was not included in the writing, especially if the writing contains a merger clause and states that no representations have been made apart from those contained in the writing. For example, the seller of a house assured the buyer orally that the plumbing in the house was lead-free. This was a deliberate lie because the seller knew that the house had lead pipes. If the buyer did not ensure that this representation was included in the recorded contract, a court may hold that the buyer cannot establish justifiable reliance on an oral representation that should have been, but was not, included in the record. In *Riversisland* the borrowers, who had fallen behind in their loan payments, entered into a written agreement with the lender under which the lender undertook to extend the loan for three months in exchange for additional collateral. The lender's representative told the borrowers that the agreement extended the loan for two years. The borrowers claimed that this was a fraudulent misrepresentation and sought to offer evidence of the misrepresentation. Although the court held that the evidence was admissible

under the fraud exception to the parol evidence rule, it pointed out that the borrowers would still have to establish fraud and suggested that they may have trouble proving the element of justifiable reliance, given their failure to read the written agreement.

The exception for mistake, fraud, and other forms of improper bargaining creates the risk that the parol evidence tendered to show mistake or misconduct may itself be perjured, thereby defeating the rule's purpose of protecting the integrity of a final writing. However, this risk is seen as necessary to ensure that the rule is not used as a means of defeating a party's right to avoidance.

§12.12.2 The False Recital Exception

Along similar lines, parol evidence is also admissible to show that a fact recited in a writing is false. For example, say that a contract between Archie, an architect, and Homer, a homeowner, provides, "In consideration for $1,500 paid by Homer, Archie agrees to draw plans…," Archie would be permitted to introduce evidence that the money was never in fact paid. The purpose of this, of course, is to prevent Homer from using the parol evidence rule to evade payment by blocking Archie's testimony of nonpayment. That testimony would, in effect, turn the recital of payment into an implied promise to pay. (You may remember from section 7.7 that parties sometimes use a false recital of consideration in an attempt to validate gifts. That is, Archie may have agreed to draw the plans for free, and the parties merely recited the fact of payment to make it appear as if Archie received consideration for his promise. In this situation, although the parol evidence of nonpayment is admissible, it could be countered by Homer's testimony that no promise was intended.)

§12.12.3 The Condition Precedent Exception

Another exception to the rule permits parol evidence to be admitted to show that the agreement was subject to a condition. Conditions are explained more fully in Chapter 16. For the present, it is sufficient to understand that the parties may reach agreement on an exchange of performances, but provide that one or both parties' performance obligation will take effect only if a future uncertain event occurs (or does not occur). For example, say that when

Archie and Homer were negotiating their contract, Archie told Homer that he was waiting to hear if he had secured a contract to supervise the construction of an office building in another city, and if he got that contract he would have to leave town for a year and could not take on Homer's project. The parties therefore signed a written memorandum subject to the oral understanding that their contract was contingent on Archie not being awarded the other contract. This understanding was not expressed in the written memorandum. Archie is then awarded the other contract and seeks to escape his obligation to Homer by testifying to the oral condition.

If the court finds the writing to be an integration, the parol evidence rule would normally exclude this testimony. However, because the testimony relates to a condition precedent to Archie's performance, the rule does not apply. The rationale has some affinity to one of the rationales for the exception for fraud and other bases of invalidity and avoidability—if a contract is subject to a condition, the contract becomes a nullity if the condition is not satisfied. This is not a convincing rationale because a contract subject to a condition precedent is a contract nevertheless. There is no reason to treat the allegation of a parol condition with any less suspicion than some other term claimed to have been left out of the writing. Nevertheless, this exception has long been recognized by courts and is reflected in Restatement, Second, §217.

Unlike the fraud exception, this exception is qualified by the requirement that the condition precedent cannot be contradictory to the express terms of the recorded contract. However, the contradiction must be clearly apparent. In *Lifetree Trading PTE, Ltd. v. Washakie Renewable Energy, LLC*, 2015 WL 3948097 (S.D.N.Y. 2015), the buyer of biodiesel fuel sold under a written contract claimed that the sale was conditional on the buyer being able to obtain a line of credit from a bank. The written contract contained no such condition. The court held that the alleged condition precedent did contradict the buyer's apparently unqualified obligation to take and pay for the fuel because the payment provision in the writing was in fact silent on the question of whether the obligation was unconditional. The court said that for an oral condition precedent to contradict a written contract, it is not enough that it is implausible. It must be impossible to reconcile with the writing. The court also rejected the argument that had the parties agreed to the condition it certainly would have been included in the writing, holding that that this test is not applicable where the parol evidence related to a

noncontradictory condition precedent.

The difficulty of applying the exception is shown by *Torres v. D'Alesso*, 910 N.Y.S.2d 1 (App. Div. 2010). A written contract for the purchase of real estate had no financing contingency and included a merger clause. The buyer did not proceed with the transaction, and the seller sued him for damages. The buyer defended the suit on the basis that the sale was subject to an oral condition precedent that had not been satisfied. He sought to testify about an oral understanding that he had reached with the seller's attorney that the attorney would hold his down payment check until he notified the attorney that he had secured financing. The buyer contended that this understanding made the contract conditional on his obtaining a loan. The trial court refused to admit this testimony and granted summary judgment in favor of the seller. The majority of the Appellate Division affirmed. It acknowledged the general rule that parol evidence is admissible to prove a condition precedent to the legal effectiveness of a written agreement, provided that the condition does not contradict the express terms of the writing. However, the majority held that the exception did not apply in this case. It held that the merger clause constituted a complete integration of the writing, which barred evidence of any alleged oral condition precedent. The court indicated that even in the absence of a merger clause, evidence of the alleged oral condition would still be inadmissible as inconsistent: It contradicted terms in the writing that required the buyer to make a down payment by a "good check" that the seller's attorney was required to place in escrow immediately.[8] The dissenting judge argued that a merger clause should not preclude evidence of an oral condition precedent because the merger clause is part of a contract that only takes effect once the condition is satisfied. Therefore, the mere existence of a merger clause cannot logically preclude testimony of the oral condition precedent to its effectiveness. The dissent also did not find inconsistency between the terms of the contract and the oral condition precedent. It acknowledged that there must necessarily be some disparity between an alleged oral condition and an apparently unconditional contract but did not consider this to amount to a contradiction. The dissent would not find inconsistency unless there was an explicit contradiction that would not allow the alleged oral condition to stand side by side with the writing.

§12.13 RESTRICTIONS ON ORAL MODIFICATION

As stated before, the parol evidence rule does not exclude testimony relating to agreements made after the writing. These are not part of the environment in which the writing was executed, and they cannot be superseded by it. However, the parties may wish to avoid disputes over possible future allegations of oral modification and may therefore insert a "no oral modification" clause in the writing, stating that no modification will be binding unless written and signed by both parties. Such clauses are difficult to enforce because courts do not usually consider that the parties can effectively restrict in advance their right to modify orally. The parties' power to modify the contract must include the power to modify the "no oral modification" clause, and the fact that they made an oral modification in itself indicates that they did so. Therefore, although a "no oral modification" clause may make it more difficult for a party to succeed in asserting an oral modification, such a clause may not be a watertight exclusion. A court may be willing to admit evidence of an alleged oral modification despite the existence of the restriction in the writing, and to leave it to the jury to decide whether the modification was in fact made.

UCC §2.209(2) appears to change this approach by expressly recognizing the effectiveness of "no oral modification" clauses in sales of goods. However, the recognition is half-hearted because §2.209(4) provides that even if the later oral modification is ineffective because the original contract requires written modification, the attempt at oral modification may still operate as a waiver of rights under the original contract. Under §2.209(5) the waiver is generally effective. It can only be retracted in relation to future performance if it has not been detrimentally relied on by the other party, and it cannot be retracted to the extent that it covers performance that has already been rendered.

§12.14 A TRANSNATIONAL PERSPECTIVE ON THE PAROL EVIDENCE RULE

As explained in section 12.4, a principal rationale for the parol evidence rule is that it keeps suspect and unreliable evidence from the factfinder, which is commonly the jury. Civilian jurisdictions do not generally have jury trials in civil cases, so there is less need for a rule that controls potentially misleading

and prejudicial evidence from the factfinder. Although civilian systems may recognize a presumption in favor of the accuracy of a written contract, and some may impose restrictions on the admission of parol evidence in some cases, the general rule is that the terms of a contract may be proved by all relevant evidence. The CISG and the UNIDROIT Principles have adopted the civilian approach and do not contain a rule restricting parol evidence. However, if the parties include a clearly drafted merger clause in the written contract, the clause is likely to be given effect to exclude any alleged oral agreement that was not incorporated into the writing.

Examples

1. Ann Cestral owned a house on a large central city lot that had been in her family for four generations. When she decided to move to a smaller condo, she agreed to sell the house to her cousin, Ava Rice. They settled on the price and Ann arranged for her attorney to draw up a contract of sale. When the document was ready for signature, Ann and Ava drove together to the attorney's office. On the way Ann said to Ava, "Our family has owned this house for a long time, and I sold it to you because I want it to remain in the family. Promise me that if you ever decide to sell the house, you will give members of our family the right of first refusal to buy it before you sell it to a stranger." Ava agreed. When Ann and Ava arrived at the attorney's office they were given a standard sales agreement which they both signed. The agreement was several pages long and had lots of details. Neither Ann nor Ava told the attorney about their discussion on the way over, so their agreement on the family's right of first refusal was not incorporated into the written contract.

   Ava took transfer of the house and moved in. Over the next couple of years, large lots in the neighborhood became very valuable because of their central location. Developers were buying houses and demolishing them so the properties could be used for high-rise condominiums. Two years after she bought the house from Ann, Ava accepted a developer's offer to buy the house for an extraordinarily high price. When Ann found out that Ava had sold the property, she confronted Ava angrily. In response, Ava waved their written contract in Ann's face and yelled, "Show me where this says I can't sell the property to anyone that I please!" Does Ava have a point?

2. Klaus Merger owned two adjoining quarter-acre lots. One had a house on it and the other, overgrown and neglected, had been used by Klaus as a dumping ground for assorted bits of junk, including a couple of broken-down cars. A few months ago Klaus placed the quarter-acre with the house on the market. Andy Gration expressed interest in buying it and negotiations ensued. Andy eventually agreed to buy it for the asking price on condition that Klaus cleared up the adjacent lot and removed all the junk. Klaus agreed to do this.

   Klaus then produced a standard-form agreement of sale that he had downloaded and printed from the Internet. The form had the usual provisions found in transactions of this kind, with blank spaces for details such as the property description and price. One of its standard terms was a merger clause, stating, "This is the entire agreement between the parties. No agreements or representations have been made save for those stated herein." There was also a large blank space at the end of the form headed "Additional Terms." Klaus filled out all the other blanks in the form but wrote nothing in the space provided for additional terms. The form therefore did not mention the clearing of the adjacent lot. Both parties signed the form.

   Klaus never cleared the lot and denies ever agreeing to do so. What are Andy's chances of proving and enforcing the oral agreement?

3. Di Aquiri owns a tavern. Margie Rita runs a small, exclusive distillery that makes a variety of health-conscious, socially responsible, nonalcoholic versions of popular liquors. Di entered into a written contract with Margie under which Di bought 100 bottles of Margie's "fat-free, sugar-free, sodium-free,[9] nonalcoholic, non-animal-tested, all-natural faux tequila." In addition to this description of the goods, the writing stated the names and addresses of the parties, the price of "$10 per bottle, subject to discount for cash," payment terms (30 days after delivery), and delivery date. It also contained a merger clause stating that the writing was intended to be "the complete, exclusive, and final expression of all terms agreed to by the parties." Both parties signed the writing, and Margie delivered the liquor on the due date.

   Consider how the parol evidence rule would affect the following different disputes that arose after delivery.

   a. Upon delivery, Di gave Margie's driver a check for $900, this being the stated contract price of $1,000 less a 10 percent discount for early

payment. Margie refuses to allow Di a 10 percent discount. She says that the parties discussed the amount of the discount orally, and she told Di that it was 5 percent. Di claims that they agreed to a 10 percent discount.

b. Di did not pay the driver. Five days later she sent a check for $900 in payment, less a 10 percent discount. Margie's problem is not with the amount of the discount, but with Di's right to it at all. She says that "cash payment" means cash on delivery, so Di is not entitled to any discount. Di says that Margie told her orally that payment within a week of delivery qualifies as cash. Margie denies ever discussing the question.

c. After delivery Di, who is very fussy about the quality of what she serves to her customers, conducted her usual chemical analysis of the faux tequila. She found that it has traces of fat and sugar (about 0.5 percent of each). Di's tests also revealed that the faux tequila contains about 0.08 percent alcohol. She wishes to reject the goods as nonconforming to the contract and to get her money back. Margie claims that she is not entitled to do this for two reasons. First, Margie has sold faux liquor to Di in the past with similar small traces of fat, sugar, and alcohol, and Di has never objected before. Second, it is widely accepted in the make-believe-liquor industry that one can never completely remove the good stuff, and beverages described as free of a substance may acceptably contain up to 1 percent of it.

4. Gordon Bleu, a chef who owns and operates a restaurant, decided to begin serving game birds to his customers. He found a recipe for pheasant and checked the catalog of his regular supplier, Fairest Fowls, Inc., to see what it cost. The catalog showed "regular" pheasant for $5.00 per pound, and "plump deluxe" pheasant for $12.50 per pound. Gordon decided that "regular" pheasant would be fine, and he called Fairest Fowls and placed an order for 50 birds.

   A couple of days later Fairest Fowls delivered the birds, accompanied by its written delivery invoice. The invoice contained the parties' names and addresses, the date, and the statement "Delivered as per order, 50 regular pheasants @$5.00 per pound. Cash on delivery." The invoice was signed by a representative of Fairest Fowls. Gordon signed the form as requested and paid the driver.[10]

   Gordon prepared the birds exactly in accordance with his recipe,

but they were tough and uneatable. Gordon complained to Fairest Fowls, which explained that it used the word “regular” in its catalog to denote scrawny birds useful only for soup, and that the more expensive “plump deluxe” variety had to be used if the flesh was to be eaten. Fairest Fowls said that “everyone knew this about pheasants,” and it was surprised that Gordon, as a trained chef, was unaware of the distinction.

Gordon insists that there is no reason why he should have understood “regular” in the sense used by Fairest Fowls and he points out that the dictionary meaning of “regular” is “usual, normal, or customary.” Fairest Fowls claims that it can produce several experts in the restaurant trade who would attest to the fact that “regular” pheasants are commonly understood to be suitable only for soup.

If Gordon and Fairest Fowls cannot settle their dispute and Gordon decides to sue Fairest Fowls for the return of his money, would Fairest Fowls be able to introduce the testimony of its expert witnesses over Gordon’s objection?

5. Beverly Hill, a movie producer, offered a leading role in a new movie to Holly Wood, an actress. The parties met with their lawyers and agents and spent the full morning negotiating the terms of the contract. By noon they had reached agreement. Their attorneys spent the rest of the day drafting the written agreement.

   The parties met again on the following morning and signed the agreement. After signing, the lawyers and agents left. Beverly and Holly remained in Beverly’s office to celebrate making the deal. As she was sipping her champagne, Holly said, “You know, I am really unhappy about that advance of $2 million that you agreed to pay me next week. I think that it should be higher, say $2.5 million. After all, I have to live until the box office receipts come in.” Beverly replied, “No problem, I’ll send you a check for $2.5 million instead.” The parties did not amend the figure of $2 million in the written contract, and the agreement to increase the advance was not otherwise recorded. The next week, Beverly sent a check of $2 million to Holly as specified in the written agreement. She denies ever agreeing to pay more. The written agreement does not have a “no oral modification” clause.

   Holly immediately sued for the additional $500,000. Beverly applied for summary judgment on the ground that the written contract clearly calls for a payment of $2 million, and no parol evidence can be

tendered by Holly to support her claim for more money. Should Beverly be granted summary judgment?

6. Buffy Beefcake is a well-known football star. He was approached by Cal Candid, who asked him if he would pose for a nude photograph to be used in a "Superjocks" calendar that Cal was producing for the next year. Cal told Buffy that the calendar would feature one naked sports hero per month. Buffy would receive a modest fee of $5,000 (really just an honorarium) for posing and allowing the use of his photo, and all profits from the sales of the calendars would go to a hospital that conducted research on the prevention of sports injuries. Buffy was a bit bashful and did not like the idea of being photographed in the nude, but he felt that it was for a good cause, so he agreed. Cal produced a five-page standard form contract, which Buffy signed without reading. Had he read it, he would have seen that it said nothing at all about the donation of the profits to the hospital. Instead, it provided that apart from the payment of the $5,000 fee, Buffy had no rights or claims whatsoever, and that all profits from the sale of the calendars would be solely the property of Cal. The writing also contained a merger clause.

   After the calendar was produced, Buffy discovered that Cal had not donated any of the calendar's proceeds to the hospital. He would like to institute action against Cal for an order compelling him to pay the profits to the hospital. Will the parol evidence rule prevent him from testifying about Cal's oral undertaking?

7. Mel Odorous operates a fish processing plant. To get rid of the detritus generated by his operation, he entered into a written contract with Pungent Puppy, Inc., a manufacturer of dog food, under which he agreed to "deliver" his entire output of fish waste to Pungent Puppy at the end of each week. The contract was for a term of two years. It recorded that the delivery of fish waste was mutually beneficial to the parties, and that neither was obliged to pay any additional consideration under the contract. Immediately after the contract was executed, the parties had a dispute. Mel says that Pungent Puppy must collect the waste from his plant, but Pungent Puppy says that it's Mel's responsibility to transport the waste to its facility. Mel claims that he has been in business for 30 years. He has always disposed of waste by giving it to fertilizer and pet food manufacturers, and the manufacturers have always collected the

waste from his plant. He therefore asserts that this was a term of his contract with Pungent Puppy. Pungent Puppy says that Mel's previous arrangements with other manufacturers are irrelevant, and that by using the word "deliver," the contract clearly places the duty on Mel to transport the waste to Pungent Puppy. If this dispute gets to the stage of litigation, would Mel's testimony about his prior practices be admissible?

Explanations

1. Yes, faithless Ava does have a point, because if Ann decides to sue on the basis of Ava's undertaking, she is confronted with two hurdles. She must first convince the judge to admit her evidence of the oral term that qualified the writing, and if she succeeds, she must then convince the jury that such a term was in fact agreed to. A written memorandum of agreement was executed, and Ann seeks to testify about a prior oral agreement. Ava may object to admission of the evidence under the parol evidence rule, and the judge must determine as a question of law whether the evidence is admissible. If not, it is excluded and the jury does not hear it, leaving Ann with no case. If Ann can jump this hurdle by satisfying the judge that the evidence is not barred by the rule and is admissible, she may then testify about the conversation before the jury. The next hurdle is to convince the jury that the conversation occurred. If Ava denies it, Ann will win only if the jury believes her over Ava.

   In the first stage of this process, the judge considers two questions. The first concerns the issue of integration and involves two possibilities: First, the writing may have been intended as the full and final expression of the parties' agreement (that is, a total or complete integration). If it is, parol evidence is inadmissible. If the writing is not a total integration, the judge goes to the next level of the preliminary inquiry to decide the issue of consistency. The parol evidence may be admitted to the extent that it is consistent with what has been recorded in the writing. Thus, the evidence may explain an ambiguity or vagueness, or it may fill a gap, but it may not contradict the writing.

   The parties' agreement is integrated if they intended the writing to fully express everything that they agreed, so that no additional undertakings were made. As usual, the parties' intent is gauged by objective evidence. Under the strict "four corners" test, the only

objective evidence that the court uses is the written contract itself. Integration is found if the writing appears complete and unambiguous, and there is no obvious gap or inadequacy. Although the facts do not set out the terms of the contract, they were apparently detailed. At face value, it seems final and complete and would be perceived as integrated under this test.

The contextual approach to integration, which is followed by many modern courts, goes beyond the face of the writing and evaluates contextual evidence to decide the question of integration. The only contextual evidence here apart from the parol evidence itself (Ann's testimony of the conversation) is the fact that the parties were members of the family that had owned the house for generations. This has a bearing on the question of integration. If the parties were strangers, dealing at arm's length, one would expect a term restricting the buyer's right to dispose freely of the property to be stated in the apparently complete writing. However, the trust and perceived mutual sentiment engendered by the family relationship might plausibly explain why the parties in this case would be happy to allow the writing to reflect only the routine legal formalities and to omit this more personal aspect of their agreement. The point, as expressed in Restatement, Second, §216(b) is whether the circumstances are such that the term might naturally be omitted from the writing.

In *Masterson v. Sine*, discussed in section 12.7, the parties' family relationship persuaded the majority that an oral agreement prohibiting the assignment of a repurchase option might naturally be made separately from the writing that granted the option. The dissent rejected the majority's test of integration and went on to say that even if that test was used, the oral agreement did not satisfy it. An agreement directly qualifying an absolute right in the written contract would not naturally be omitted from the writing. These contrary approaches show that the resolution of the question of integration largely depends on how liberal a view the court takes on this issue. It is conceivable but not assured that a court could find that the writing executed by Ann and Ava was not intended as a complete expression of the parties' agreement.

If the judge finds that the writing is not fully integrated, Ann's evidence is admissible provided that it does not contradict the writing. The oral agreement does not directly contradict an express term, but a

restriction on Ava's right to transfer her property freely does contradict the normal legal assumption that an owner has the right to dispose of her property as she sees fit. This is a more subtle contradiction. A court that distrusts evidence of alleged prior oral agreement can make a good argument that this is a contradiction, but a court that is more amenable to the admission of parol evidence can make an equally good contrary argument. Again, this difference of view appears in the majority and dissenting opinions in *Masterson*. The narrower test of inconsistency would allow Ann to go to trial and to attempt to convince the jury that the oral agreement was made. A wider view would enable the court to dispose of Ann's case summarily.

2. The analysis of this problem is the same as that in Example 1, but Andy's problem is worse than Ann's. To begin with, there is a merger clause in the writing, and an unfilled blank suitable for inserting a term like this. Courts tend to be wary of standard-form merger clauses, because they may not have been conspicuous or understood, but this does not mean that such clauses are invariably treated as ineffective. A signatory has a duty to read the document before signing it, even if the document is a standard form, and one who fails to exercise that duty cannot expect relief unless the bargaining circumstances compel the conclusion of unfair imposition. (This issue is raised in sections 4.1.5 and 5.3 and is fully discussed in section 13.12.) There is nothing in the facts of this case to indicate that Andy could not be expected to read and understand the writing or that Klaus had a bargaining advantage that allowed him to impose unfairly one-sided terms.

   On a "four corners" test the apparent completeness of the document, the unfilled blank space, and the merger clause will surely lead to the conclusion of integration. Even on a contextual approach, the terms of the writing, including the merger clause, are taken seriously. However, the contextual approach at least gives Andy a shot at explaining why the apparent integration was not intended as such. In other words, Andy is given the opportunity to persuade the court that despite the existence of an apparently complete and final writing, this term might naturally have been agreed to separately. On these facts, this does not seem like an easy task. One basis for making this argument is that a standard form was used which does not admit the addition of special terms tailored to the transaction. However, that will not work

here because there was space for its insertion on the form. Family connection or some other relationship may explain an informal approach to some special term of a contract, as discussed in Example 1, but Andy had no prior connection with Klaus.

Section 12.11 discusses the collateral agreement rule. As you probably noticed, the facts of this Example are reminiscent of *Mitchell v. Lath*, which found the rule to be inapplicable to an oral promise to remove an ice house from property adjacent to the property sold. The underlying rationale of the collateral agreement rule is similar to that of the Restatement, Second, test. In fact, the tests are really just alternative formulations of the same principle. However, the collateral agreement rule is more difficult to satisfy because it requires the parol agreement to be distinct enough from the writing to qualify as a separate but related agreement. To satisfy this standard, the subject matter of the oral and written agreements must cover different performances with identifiably separate consideration. It is hard to imagine that an oral agreement could qualify as separate if it might not naturally be agreed to separately. In addition, Andy made no promise of additional consideration for the oral promise, and there is no indication that the parties intended to allocate any portion of the property's purchase price to the clearing of the adjacent land.

3. This Example involves a sale of goods, so UCC §2.202, the Article 2 version of the parol evidence rule, applies. In general principle, it is substantially similar to the contemporary common law rule, so many courts would not answer these questions differently had this not been a sale of goods. The writing in this case is apparently intended as a complete integration. It contains all the terms essential to a sales contract and it has a merger clause. Notwithstanding, it is not a watertight final and complete memorial of agreement, so most of the parol evidence suggested by the questions should be admissible.
   a. Despite the attempt at integration, the parties did not fully express their agreement. They provided for a discount but failed to specify its amount. With regard to this term, the writing cannot be a complete and final expression of their agreement, so evidence of what they agreed orally is admissible to supplement it. Note that neither denies making an oral agreement, but they argue about what was agreed. Neither party's evidence is inconsistent with the writing, so it will all

be admitted, and the factfinder will have to decide whose version of the discussion is correct.

b. Although the amount of the discount was omitted, the existence of that gap does not give Di license to produce parol evidence on other terms that are fully, clearly, and finally expressed in the writing. On a "four corners" test, the agreement is apparently integrated on this issue, and Di would probably prevail on the plain meaning of the word "cash." However, Comment 1 to §2.202 makes it clear that the "four corners" approach is not to be used in sales of goods, and that meaning must be determined in the commercial context in which the words were used. This does not mean that we abandon all restrictions on admissibility merely because one of the parties is willing to testify as to a meaning different from the obvious ordinary meaning of the writing. The contextual evidence must point to a meaning of which the writing is reasonably susceptible—it must persuade the court that there is some basis for going beyond the apparent clarity of the writing. If not, the evidence should not be admitted because the party offering it has not shown that the apparently integrated writing suffers from an ambiguity or vagueness that requires explanation. (Alternatively, even if there is no integration, the contended meaning does not explain but contradicts the writing.)

   The only contextual evidence of the meaning of "cash" is the disputed parol evidence itself: Di's allegation about what was said during negotiations. This self-serving testimony is apparently not corroborated by more objective evidence, such as usage or course of dealing. In the absence of some indication that there is a common understanding or a practice between the parties that "cash" means credit of up to a week, it is difficult to reconcile Di's evidence with the word's normal meaning. Even under the more liberal rule of the UCC (and Restatement, Second), the evidence should be excluded.

c. Margie is trying to establish both a course of dealing and a trade usage to show that her faux tequila conforms to the contract even though it has traces of fat, sugar, and alcohol. Section 2.202(a) makes it clear that even if a writing appears fully integrated and has a merger clause, evidence of usage and course of dealing should always be allowed to supplement or explain it. However, they may not contradict it. The rationale for this more liberal rule is twofold. First, parties normally

take it for granted that a transaction is subject to well-established custom or their own prior practices, so they are unlikely to take the trouble of spelling them out in the writing. Second, the evidence to establish these facts is objective and harder to make up than an account of what was said in negotiations. Therefore, unless the parties negate usages or prior understandings by clear wording (in which case the evidence would contradict the writing), they are assumed to apply despite the silence of an apparently complete agreement.

There is nothing in the writing to indicate that the parties deliberately excluded the usage or practice claimed by Margie, so the general merger clause does not keep out the evidence, and it is admissible unless it is inconsistent with the writing. The writing unqualifiedly describes the tequila as free of fat, sugar, and alcohol, so it could be argued that the writing is contradicted by testimony that small quantities of these substances are acceptable. This again raises the difficult question of deciding whether a qualification to an absolute undertaking is a supplementation or a contradiction. There is no sure dividing line, but courts tend to favor admission of this kind of objective evidence in cases of doubt, requiring quite strong wording of negation to exclude it. A classic example is *Columbia Nitrogen Corp. v. Royster Co.*, 451 F.2d 3 (4th Cir. 1971), in which the written contract provided for the purchase of a specific minimum tonnage of phosphate. The buyer failed to take the minimum and claimed that because of market uncertainties in the industry it was accepted in the trade that quantity specifications were mere projections. Prior transactions between the parties were also alleged to support that reading of the quantity term. The court of appeals held the evidence admissible, reversing the trial court's determination that it contradicted the writing. Do not forget that the decision to admit the evidence is just the first step in the process. Margie must then convince the factfinder that the course of dealing and trade usage did exist and that they support her position.

4. The issue here is the meaning of the word "regular." Gordon contends that its plain meaning is self-evident, but Fairest Fowls argues that it is ambiguous if understood in light of trade usage. If Fairest Fowls is right, we need not be concerned about whether the parties expected the written invoice to be an integration. The ambiguity of the word means that, at

least insofar as the quality of the pheasant is concerned, the writing did not succeed as a complete and final expression of what the parties agreed. Evidence may therefore be admitted to explain the meaning of "regular" provided that the evidence supports a meaning reconcilable with the writing.

A court adopting a "four corners" approach may be inclined to find that there is no ambiguity about "regular" in the context of the writing as a whole, and that it can only have the meaning contended by Gordon. However, such an approach is clearly not appropriate in a sale of goods, because UCC §2.202, Comment I rejects it and calls for consideration of the commercial context in establishing meaning. Section 2.202 gives very strong credence to trade usage, which is presumed to enter the contract unless the parties clearly and unequivocally indicate a contrary intent or the usage cannot be reconciled with the writing. As nothing else in the writing even remotely pertains to the quality of the pheasant, the only language that must be reconciled with the proffered evidence is the word "regular" itself. If looked at from the patterns of normal speech, it is hard to think of "regular" as meaning "old and scrawny." However, from the perspective of the trade in which the parties are engaged,[11] the evidence suggests that there is no inconsistency. That is, having decided that trade usage may support such an esoteric meaning, rendering the word ambiguous, we must necessarily conclude that the meaning is not inconsistent with the word. The expert testimony should therefore not be excluded as parol evidence, and Fairest Fowls should be able to present it to persuade the factfinder that the words mean what it contends.

5. The alleged oral term for the payment of $2.5 million directly contradicts the clear and unambiguous provision in the writing for payment of $2 million. Whether or not the agreement is fully integrated, it does definitively express the amount of the advance, and there is no way in which the written and alleged oral terms can be reconciled by interpretation. Therefore, if the oral agreement is contemporaneous with the writing, evidence of it would be barred by the parol evidence rule. However, if the oral agreement was made subsequent to the writing, the parol evidence rule does not apply, and there is no provision in the agreement barring oral modifications. This Example focuses on what is meant by a subsequent agreement for the purposes of the parol evidence

rule. If we take a literal approach, the oral agreement was unquestionably made after the writing, and the evidence is admissible. However, such a technical distinction may lead to an absurd result that places too much emphasis on the sequence of events in a single interaction. The alleged amendment was made almost immediately after the execution of the writing, while the parties were still together following the meeting at which it was signed. If the parties really did agree to change the amount of the advance, it would have been easy and natural for them to alter the writing to reflect the change. The fact that the writing was not amended casts suspicion on the claim that the parties agreed to the change. A possible argument that Holly could make is that the departure of the parties' lawyers and agents terminated the stage during which the writing was executed, so that the informal agreement to increase the advance should be treated as subsequent.[12]

A timing issue similar to this arose in *Kehr Packages, Inc. v. Fidelity Bank*, discussed in section 12.3.4. The borrowers alleged that after the written agreement was signed, they made an oral agreement with the lender to increase the amount of the loan. The court found the alleged oral agreement to be contemporaneous with the writing because it was made in the course of the closing process during which the writing had been executed.

6. Buffy can obtain the order only if he can prove that Cal's undertaking to donate the profits to the hospital was a term of the contract. His problem is that this term was agreed orally before the writing was executed and it is absent from the writing. Buffy cannot claim that he did not realize at the time of signing the written contract that it failed to reflect the oral understanding. He had a duty to read it and is bound by its terms. (In *Myskina v. Conde Nast Publications, Inc.*, discussed in section 12.7, the court invoked the duty to read and firmly rejected Myskina's argument that she did not read the release because she was not fluent in English.) Although we do not have the full terms of the writing, it is compendious and is likely a fully integrated agreement. The fact that it has a merger clause adds weight to this conclusion. Even if the agreement is found not to be integrated, a prior oral promise to donate the profits to a hospital likely contradicts the express term that the profits belong to Cal alone.

   Although there is not much chance that the parol agreement would be admitted under the normal operation of the parol evidence rule, the

facts make out a case for application of the fraud exception. As a matter of public policy, courts do not allow a party to use the parol evidence rule to mask a fraud, so parol evidence is admissible to the extent that it is offered to establish fraud. (See *America's Directories, Inc. v. Stellhorn One Hour Photo, Inc.*, discussed in section 12.12.) We will leave a detailed discussion of the elements of fraud to section 13.6. For now, it is enough to note that a victim of fraud can avoid a contract if he can show that the other party made a fraudulent misrepresentation that justifiably induced him to enter the contract. Although fraud usually involves a misrepresentation of fact, it can also arise where a person makes a contractual promise with the deliberate intention of breaking it, or where a person deliberately misrepresents the content of the document presented for signature. As we see in section 13.6, Buffy's biggest problem in establishing fraud will be to show that he was justified in relying on an oral representation that was not included in the writing.

7. This Example seeks to surpass *Maday v. Grathwohl* in the repulsiveness of the subject matter of the contract. Unlike that case, Mel is not claiming that the parties made a prior oral agreement that speaks to the issue in dispute. Rather, it seems that the parties did not address this question at all in any negotiations or communications, and that each had a different understanding of who would be responsible for the transport of the waste. The word "deliver," used in their written contract, is ambiguous. It could mean that Mel must physically transport the waste to Pungent Puppy, or it could mean (as it is used in UCC §2.503) that Mel must hold the waste for Pungent Puppy to collect. If the term is ambiguous, there is no bar on parol evidence to establish its meaning. However, Mel's assertion about his past practices with other pet food manufacturers is not really parol evidence at all. His arrangements with previous manufacturers do not constitute a course of dealing because these transactions did not involve Pungent Puppy. Therefore, the exclusion of this evidence would be based on grounds of irrelevance, rather than under the parol evidence rule. Mel may seek to argue that his past arrangements with other manufacturers reflect a more widespread practice in the market that constitutes a trade usage, which would be admissible to clarify the meaning of the ambiguous term "deliver." However, Mel's dealings with other manufacturers in the past are not,

on their own, sufficient to establish trade usage. Mel would have to go beyond his own transactions to show that collection of waste by manufacturers is a practice that is currently and widely observed in the market in which the parties operate.

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1. Modifications are dealt with in sections 7.5.2 and 13.9. The written memorial of agreement may itself seek to prevent future oral modifications by requiring that all modifications must be in writing and signed by the parties. The effectiveness of such a provision is discussed in section 12.12.

2. The principal impact of characterizing the parol evidence rule as a rule of substantive law is on matters of procedure. For example, if a federal court deals with a contract case, it follows its own rules of evidence, but because the parol evidence rule is treated as a rule of substantive law, the court is obliged to follow the rule as formulated in state law. Also, if it was a rule of evidence, a party could waive it by failing to object to the evidence at trial. As a rule of substantive law, it can be raised on appeal despite the failure to object at trial.

3. Merger clauses are explained later in this section.

4. Myskina did not argue (and the court did not consider) that the alleged oral agreement was not subject to the parol evidence rule because it was made subsequent to the written release. This probably would not have been a good argument. Even though the oral agreement followed the writing, which was executed at the beginning of the photo shoot, they did occur during the same period of interaction and should be viewed as contemporaneous. (*See* the *Kehr Packages* case discussed in section 12.3.2.)

5. One odd feature of the case was that the written contract contained a merger clause, which the court found on its face to be a clear integration of the writing. However, the court's discussion of integration comes after its determination of contradiction. Logically, the court should have decided the integration question first, because once the agreement is integrated, no parol evidence comes in, even if consistent. This illustrates the point made in section 12.6, and reinforced in the next paragraph, that courts do not always neatly separate questions of contradiction and integration.

6. Comment 1(c) to §2.202 states further that the court does not need to find that the writing is ambiguous as a precondition to admissibility of this type of evidence.

7. Fraud usually involves a misrepresentation of fact. However, a misrepresentation of intent can also constitute fraud if, at the time of entering the contract, the party making the misrepresentation intends to renege on his promise.

8. Apart from integration and inconsistency, the majority advanced other grounds for refusing to admit the evidence: It considered that the formalities imposed on a sale of real property by the statute of frauds made it inappropriate to consider evidence of an oral condition in relation to a real estate transaction. The majority also doubted that the alleged undertaking of the seller's attorney was clear enough to constitute agreement to a condition precedent.

9. It is also taste-free, but the agreement did not specify that.

10. If this Example sounds familiar, it is because it is based on Example 2 of Chapter 10. That example involved the interpretation of an oral contract. In the present Example, the contract is recorded in the invoice, which is a written memorial of agreement for parol evidence purposes. The goal of this Example is to allow you to consider the parol evidence issue that was absent from Example 2 of Chapter 10. After working through this Example, you may find it helpful to review Example 2 of Chapter 10 to compare interpretational issues in the absence of the parol evidence rule. (Note that some of the facts concerning the evidence have been changed or simplified in this Example.)

11. In Example 2 of Chapter 10, the issue of defining the trade and holding Gordon accountable for the usage is discussed. This issue is not duplicated here, and the facts indicate that the expert evidence covers the restaurant business, of which Gordon is a member.

12. Note that even if the court treats the informal agreement as a subsequent modification, the admission of this evidence may not ultimately help Holly in her claim for the extra $500,000. She apparently did not give any consideration to Beverly for the promise to increase the payment.

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CHAPTER 6
PAROL EVIDENCE AND INTERPRETATION

*ChapterScope*_____

This chapter focuses on two areas dealing with the judicial construction of contracts: the parol evidence rule, and the interpretation of contract terms.

- **Parol evidence rule:** The parol evidence rule governs the effect of a ***written agreement*** on ***any prior oral or written agreements*** between the parties. Simplifying somewhat, the rule provides that a writing intended by the parties to be a full and final expression of their agreement may not be ***supplemented or contradicted*** by any oral or written agreements made prior to the writing.
  - **Subsequent oral agreement:** The parol evidence rule does not bar admission of evidence of oral agreements made ***after*** the writing.
  - **Interpretation:** The parol evidence rule does ***not*** bar admission of evidence about the ***meaning*** the parties intended to give to particular contract terms.
- **Rules of interpretation:** There are a number of general rules or "maxims" for interpreting the meaning of ambiguous contractual terms. For instance:
  - **Ambiguous terms:** Generally, an ambiguous term will be construed against the draftsman.
  - **Custom:** Evidence of "custom" may be admitted to show that the parties intended for a contract term to have a particular meaning. Sources of custom include ***"course of performance"*** (how the parties have interpreted the term during the life of the present contract), "course of dealing" (how the parties have interpreted the same term in prior contracts between them) and "trade usage" (the meaning attached to a term within a particular industry).
- **Omitted terms:** The court may ***supply*** a reasonable term in a situation where the contract is silent. (*Example:* Courts in contract cases frequently supply a duty to act in good faith.)

I. THE PAROL EVIDENCE RULE GENERALLY

A. How the rule applies: Before signing a written agreement, the parties typically engage in preliminary oral negotiations. Furthermore, they may exchange pieces of paper (e.g., letters, lists of items for discussion, etc.) that are not intended to be contracts in themselves. When the written contract is finally signed, it may fail to include any treatment of some of the issues raised in these preliminary oral discussions or written documents, or it may deal with these issues in a way that is different from their treatment in the earlier discussions. When this occurs, to what extent may one party later try to prove in court that these earlier oral or written discussions are part of the contract, despite their absence from the writing?

1. Effect of the rule: The "parol evidence rule," whose precise formulation varies from one authority to another, attempts to answer this question. In its more strict forms, the parol evidence rule results in barring from the factfinder's consideration ***all evidence of certain preliminary agreements that are not contained in the final writing***, even though this evidence might persuasively establish that the preliminary agreement did in fact take place and that the parties intended it to remain part of their deal despite its absence from the writing.

II. TOTAL AND PARTIAL INTEGRATION

A. The concept of "integration": A written document does not always represent a deal that the parties consider final. The writing may, for instance, be intended only as a tentative draft of their agreement. But if the parties do intend a document to represent the ***final expression of their agreement***, the document is said to be an ***"integration"*** of their agreement. The parol evidence rule applies, as we shall see, only to documents which are integrations, i.e., final expressions of agreement.

B. "Partial" vs. "total" integrations: Once it is determined that a document is an integration (i.e., a final expression of agreement), it must be determined whether the parties intended that integration to contain all of the details of their agreement, or only some of these details. If the document is intended only as a memorandum of the agreement, it may state only the most important details, and leave the others to the parties' recollection.

1. **Partial integration:** If the document is not intended by the parties to include all details of their agreement, it is said to be a ***"partial"*** integration.

2. **Total integration:** If, on the other hand, the document is intended by the parties to include all the details of their agreement, it is called a ***"total"*** integration.

C. Statement of the parol evidence rule: Having defined the concepts of "partial integration" and "total integration," we are now ready to state the parol evidence rule. The rule has, in effect, two parts, one dealing with partial integrations, and the other with total integrations. The rule provides as follows:

[1] **Partial integration:** When a writing is a ***partial*** integration, no evidence of prior or contemporaneous agreements or negotiations (oral or written) may be admitted if this evidence would ***contradict*** a term of the writing.

[2] **Total integration:** When a document is a ***total*** integration, no evidence of prior or contemporaneous agreements or negotiations (oral or written) may be admitted which would ***either contradict or even add to*** the writing.

1. **Summary of rule:** In summary, the parol evidence rule provides that evidence of prior agreement:

□ may never be admitted to ***contradict an integrated writing***, and

□ may furthermore not even ***supplement*** an integration that is intended to be ***complete***.

See Rest. 2d, § 213. ?

Example: Seller and Buyer make an oral agreement for the sale of the Ardsley Acres Hotel, together with all the furniture in the hotel. They reach oral agreement as to the purchase price of the hotel, and also agree that Buyer shall have one year in which to complete payment of this price. The parties then employ a lawyer to prepare a written contract. He does so, and they sign it. It does not mention furniture, or make any reference to personal property. It also provides that Buyer shall only have six months in which to complete payment.

If Seller can show that the written contract was intended as the final expression of the parties' agreement (i.e., that it is an ***integration***), Buyer will not be allowed to show that the original oral agreement gave him a year, rather than six months, to pay. He would not be allowed to show this because of the rule that prior oral or written evidence may not be introduced to contradict an integrated writing.

If Seller can also show that the written agreement was intended to be a ***complete*** or ***total*** integration (i.e., that it contained all the terms on which the parties were finally in agreement), Buyer would not be allowed to prove that hotel furniture was to be included in the deal. This is because the oral agreement as to furniture would be a consistent additional term, and may not be introduced to supplement a total integration. If, on the other hand, Seller is unable to show that there is a total integration (as might be the case if the writing contains a statement that it deals only with the hotel real estate, and leaves untouched any oral agreement as to personal property that the parties might have reached), Buyer will be able to introduce evidence that the parties agreed to include the furniture. See Rest. 2d, § 213, Illustration 4.

Note: Observe that the parol evidence rule protects the sanctity of final written documents, even at the expense of fulfilling the parties' actual intentions. Thus in the above example, once Seller is able to show that the written document was intended to be a total integration, the court must ignore all evidence by Buyer that furniture was included in the deal, ***even if this evidence would show absolutely conclusively that the parties did intend to include the furniture***. However, the force of this rule is somewhat dissipated by the fact that, as it is discussed below, the judge, in determining whether the writing is an integration, and whether it is partial or complete, may consider all evidence.

D. Contemporaneous and subsequent expressions: Thus far, we have spoken only of oral or written expressions that occur ***prior to*** a written integration. If an oral agreement occurs ***at the same time as*** the writing is signed, most courts treat it as they would treat a prior oral statement, i.e., precluding it from being introduced to contradict the writing, or to supplement the writing if it is a total integration.

1. Contemporaneous writing: If an ***ancillary writing*** is signed at the same time a formal document is signed, the ancillary document will usually be treated as ***part of the writing***, and will thus not be subject to the parol evidence rule. In other words, the writings will be treated as if they formed one document, and everything in them will be considered by the court in construing the contract. C&P, p. 122.

2. Subsequent agreements: It is essential to remember that the parol evidence rule ***never bars consideration of subsequent oral agreements***. That is, ***a written contract may always be modified after its execution, by an oral agreement.*** "The most ironclad written contract can always be cut in two by the acetylene torch of parol modification supported by adequate proof." *Wagner v. Graziano Constr. Co.*, 136 A.2d 82 (Pa. 1957).

a. No-oral-modification clauses: Of course, the parties often put into

their writing a ***"no oral modification" (N.O.M.) clause.*** As the name implies, an N.O.M. clause says that the writing cannot be modified except via an amendment signed by both parties.

i. **Enforceability:** Courts typically ***enforce*** N.O.M. clauses, holding that where such a clause exists, a true "modification" or amendment to the writing cannot be made except by another signed writing.

ii. **Subject to waiver:** However, the practical effect of N.O.M. clauses is frequently ***weakened*** by courts' use of the doctrine of ***"waiver"*** — the contract is not modified by a later oral agreement, but *A* is frequently held to have waived the benefit of the N.O.M. clause by inducing *B* to rely on *A*'s oral statements that some provision of the contract won't be insisted upon.

iii. **Change orders in construction contracts:** The tendency of the waiver doctrine to weaken the effect of an N.O.M. clause is frequently illustrated in ***construction contracts***. Such contracts generally contain a type of N.O.M. clause inserted for the owner's benefit, providing that ***no request for extra work*** will be effective unless it is made in a writing signed by the owner. Yet this kind of clause is often ineffective because of the waiver doctrine.

Example: A construction contract between Own and Contractor has a clause saying that no request by the owner or architect for extra work will be effective unless in a writing signed by Own. Own requests that Contractor add one foot in length to the porch Contractor is building. Contractor says, "OK, but that'll cost you $1,000 extra; please sign the change order." Own says, "I don't want to be bothered with the paperwork, after all, we're good friends and we don't need the written contract to tell us what we've worked out, right? Just do the work, and I'll make sure you're paid." Contractor does the work, and Own refuses to pay.

If the court believes that this conversation happened, the court is likely to hold that Own's oral statement constituted a waiver by him of the benefits of the N.O.M. clause, so that Own will have to pay the agreed-upon extra amount.

iv. **Explicit modification required:** But for a "no-oral-modification" clause to be rendered ineffective, it is usually required that something more occur than a ***mere oral agreement*** to overlook the clause. For a waiver of the no-oral-modifications

clause to be effective, the party trying to escape from the clause must generally show that she ***relied***, i.e., that she ***materially changed her position*** in reliance upon the waiver.

Example: On the facts of the above example, Contractor's doing the work clearly constitutes material reliance, so waiver would almost certainly be found. But suppose the "Just do the work" conversation occurred but that before Contractor began the work, Own changed his mind and said, "Don't do it." Here, the court would probably *not* find that a waiver of the N.O.M. clause had occurred, because Contractor didn't materially rely on the waiver before it was withdrawn.

v. **UCC:** When a "no oral modification" clause is present in a contract governed by the ***UCC***, a similar rule regarding waiver applies. Recall that under UCC § 2-209(2), a no-oral-modification clause will generally be effective. (See *supra*, p. 132.) But even though this statutory provision seems to make no-oral-modification clauses more readily enforced than they are at common law, § 2-209(4) undercuts some of the practical impact of using such a clause: "Although an attempt at modification…does not satisfy the requirements of [a valid no-oral-modification clause] it can operate as a ***waiver***."

So if the parties purport to make an oral modification of a sales contract containing a no-oral-modification clause, the attempted modification will probably be ***effective as a waiver,*** at least where the party claiming waiver has materially changed his position in reliance. See W&S, pp. 32-33.

E. The UCC's parol evidence rule: The parol evidence rule set forth in the UCC is basically the same as the common-law version of the rule, described above.

1. Text of rule: § 2-202 provides that: "Terms with respect to which the confirmatory memoranda of the parties agree or which are otherwise set forth in a writing intended by the parties as a ***final expression*** of their agreement with respect to such terms as are included therein ***may not be contradicted*** by evidence of ***any prior agreement or of a contemporaneous oral agreement*** but may be ***explained or supplemented***:

(a) by course of performance, course of dealing or usage of trade; and

(b) by evidence of ***consistent additional terms*** unless the court finds

the writing to have been intended also as a ***complete and exclusive statement*** of the agreement."

2. **Summary of Code provision:** So to summarize the Code rule:
   - □ If a writing is a ***final*** expression of the parties' agreement (i.e., an ***"integration"***), it ***may not be contradicted*** by evidence of any prior agreement, whether written or oral, nor of any oral agreement that is contemporaneous with the writing.
   - □ Even a final expression may, however, be ***"explained or supplemented"*** (as opposed to "contradicted") by:
     - □ evidence of course of dealing, trade usage, and course of performance (all discussed *infra*, p. 193); and by
     - □ evidence of ***"consistent additional terms,"*** unless the court concludes that the writing was intended not only as a final statement, but also as a "complete and exclusive statement" of the terms of the agreement (i.e., a ***"complete"*** or ***"total"*** integration).
3. **Special terms:** Under the UCC (and probably in most non-UCC cases as well), even a complete integration may be explained or interpreted by reference to "course of dealing," "usage of trade," and "course of performance," terms which are discussed in the later part of this chapter. (Evidence relating to these terms does not usually provide the substance of the agreement, but instead aids in the interpretation of the meaning of the parties' own words; for this reason, such evidence is not subject to the parol evidence rule, either under the UCC or under non-UCC common law.)
4. **Difference between Code and non-Code law:** The Code language quoted above sets forth almost precisely the same parol evidence rule as was summarized earlier in the non-Code context. The principal differences between the Code rule and non-Code common law relate to how the judge determines the existence of an integration, and how she determines whether an integration is "complete" or "partial." This topic is discussed immediately below.

Quiz Yourself on

THE PAROL EVIDENCE RULE, AND "TOTAL" VS. "PARTIAL" INTEGRATION

46. Washington and Adams agree for Adams to sell Washington 1000 Declaration of Independence Commemorative Placemats, which Washington intends to re-sell. They sign a written contract, which both parties intend to represent all aspects of their agreement, and which both parties intend to be final. One day after the writing is signed, the parties orally agree that the price to Washington will be adjusted from $ .40 per mat to $ .30. The writing says nothing about subsequent oral agreements. Adams ships the mats, and bills at the $ .40 price. If Washington refuses to pay more than $ .30 and Adams sues, may Washington prove in court that the oral modification occurred?

47. Cagney and Lacey enter into a written contract to open "Tried and True," a store specializing in used guns recovered from murder scenes. The writing is a 2-paragraph handwritten document, prepared during a 1-hour meeting. The writing states that each party will receive 50 percent of any net profits and that each will devote 30 hours a week to the venture. Both parties regard the writing as a final expression of their deal.

(A) Subsequently, Cagney sues Lacey for breach because Lacey has been working only 20 hours per week over the last few months, which are summer months. In defense, Lacey attempts to testify that just prior to the parties' signing of the writing, Cagney orally agreed that for the approximately four months a year when Lacey's young children were on vacation from school, Lacey could work only 20 hours a week. Is Lacey's testimony admissible?

(B) Assume that in the same lawsuit, Lacey counterclaims for lost profits due to certain small merchandise discounts that Cagney gave to her adult children. Cagney tries to testify that before the writing was signed, the parties orally agreed that each party could sell up to $500 per year in merchandise, at a 20% discount, to members of that party's immediate family. The writing says nothing about whether and when such merchandise discounts will be given. Is Cagney's testimony admissible?

Answers

46. Yes. The parol evidence rule would prevent Washington from showing an oral agreement that occurred prior to or contemporaneously with the writing, and that either contradicted or supplemented the writing. But the parol evidence rule doesn't prevent (or even deal with) *subsequent* oral modifications to contracts. Since the writing has no No Oral Modification clause, the oral modification may be proved (and will be enforced).

47. (A) No. The parol evidence rule bars any evidence of a prior or contemporaneous oral agreement where such evidence would ***contradict*** a term of a written contract that was intended as a "final" (even if not "total") integration, i.e., expression of the parties' agreement. The facts tell you that the writing is a final integration, so this rule applies here. The writing specifically requires both parties to work 30 hours a week, and an oral clause that would reduce Lacey's time by 1/3 for 1/3 of the year certainly seems to be a contradiction of the agreement, not a mere supplementation or interpretation of it.

(B) Yes, probably. The merchandise-discount clause merely supplements the writing, and doesn't contradict it, since the writing is silent on the subject. The parole evidence rule provides that a final integration may be supplemented (not contradicted) by prior oral agreement if and only if the integration is partial rather than total (that is, only if the writing was *not* regarded by the parties as covering all aspects of the deal). Here, the relatively short length of the writing, the fact that it was handwritten, and the fact that it was entirely drafted in one hour, all make it likely that the parties intended the integration to be merely partial. If so, the supplementary oral term will be admissible.

III. THE ROLES OF THE JUDGE AND JURY

A. Preliminary determinations made by judge: One of the principal reasons for the parol evidence rule was the fear that juries would not recognize the superior trustworthiness of a written document, as compared to oral testimony about alleged oral agreements. To make sure that this function of the rule is fulfilled, virtually all courts hold that a determination of whether a writing was intended as an integration, and if so, whether the integration is "partial" or "total," is to be made ***by the***

judge, not the jury. Furthermore, courts almost universally hold that it is the judge who decides whether particular evidence would supplement the terms of a complete integration. See Rest. 2d, §§ 209(2), 210(3).

1. **Consequence:** Because the modern tendency is to allow the judge to consider almost all evidence in making these decisions, the parol evidence rule has much more bite in a jury trial (where operation of the rule may mean that the trier of fact is prevented from ever considering allegations of previous oral agreements) than where the case is tried to a judge.

B. Conflicting views on how judges decide: How is the trial judge to go about determining whether a writing is a partial integration, a total integration, or no integration at all? And how is she to decide whether particular evidence contradicts, supplements, or merely explains, the document? Should she answer these questions solely by examining the writing, or may he consider oral evidence about the alleged prior agreements? These questions relating to the trial judge's role in applying the parol evidence rule have given rise to one of the greatest disputes in the history of modern contract law, a dispute between Professors Williston and Corbin. In addition to the Williston and Corbin views, we shall summarize here a third, "middle" view, set forth in the UCC.

1. **Williston's view:** Professor Williston believed that the judge should decide whether a writing was an integration, whether it was "partial" or "total," and whether a given piece of evidence about a prior agreement contradicted or supplemented the writing, by the following steps:

   a. Merger clause: First, the trial judge should examine the writing itself. Many writings contain a ***"merger" clause***, i.e., a clause indicating that the writing constitutes the sole agreement between the parties. Such a clause will ***conclusively establish that the document is a total integration***, unless the document is obviously incomplete, or the merger clause was included as the result of fraud or mistake, or there is some other reason to set aside the contract. (Fraud, mistake, and other facts that show the contract to be void or voidable, are never barred by the parol evidence rule; see *infra*, p. 184-187.)

b. Rest of writing: If there is no merger clause, then, according to Williston, the writing as a whole should be examined. If the writing is obviously incomplete on its face (e.g., a lease with no mention of price), or if it expresses the duty of only one of the parties (as is the case with deeds, promissory notes, etc.), the writing will be treated as a partial integration. Therefore, consistent additional terms may be demonstrated through oral evidence. If, on the other hand, the writing appears on its face to be a complete expression of the rights and duties of both parties, it should be deemed a total integration unless the alleged oral additional terms were ones which might naturally have been made as a separate agreement by reasonable parties in the position of the actual parties to the contract. 4 Williston §§ 633-39. C&P, pp. 131-132.

c. "Four corners" approach: Williston would have the trial judge determine whether there is an integration, and whether it is total or partial, by looking ***exclusively at the document.*** This approach is sometimes called the ***"four corners"*** approach (because the judge does not look beyond the "four corners" of the document in making his decision). Williston thus adopts a "reasonable person" standard; he is interested in whether ***reasonable people*** in the position of the contracting parties would have naturally put the terms of the alleged oral agreement into the final writing, or would instead have left them out.

2. The Corbin view: Professor Corbin took a sharply different view from Professor Williston as to how the court should handle parol evidence questions, particularly how it should decide whether integration was partial or total. He believed that the ***actual intention*** of the parties should be looked to in disposing of this question. If all the evidence introduced by the parties shows that they in fact did not intend the written contract to contain all terms of their agreement, and that in fact other oral agreements were made and were intended to be binding, this evidence would then be given to the jury. Corbin thus places much less emphasis on the writing itself than did Williston, and looks much more to the ***actual intent*** of the parties. See Corbin, § 582; C&P, pp. 132-133.

a. Effect of Corbin position: The Corbin view comes close to

eviscerating the parol evidence rule. Since the court uses all available evidence to determine whether the parties intended the writing to replace previous oral agreements, the court in effect follows the general rule that a later agreement supersedes an earlier one, if the parties intend that it do so. No parol evidence rule is necessary for this general rule to be followed. Corbin's view of the parol evidence rule strips the written document of the almost sacrosanct quality that Williston gave it. See Murray, pp. 231-32.

3. **The UCC approach:** The UCC, like both Corbin and Williston, entrusts to the trial judge the decision about whether a partial or total integration exists. In instructing the judge on how to make this decision, the Code seems to take a middle view between Williston's and Corbin's (though probably closer to Corbin's).

   a. **Text of UCC:** In explaining § 2-202(b)'s statement that evidence of "consistent additional terms" may be given unless the court finds that the writing was intended as a "complete and exclusive statement of the agreement" (i.e., a total integration), Comment 3 states: "If the additional terms are such that, if agreed upon, they ***would certainly*** have been included in the document in the view of the court, then evidence of their alleged making must be kept from the trier of fact."

   b. **Effect:** Whereas Williston would not allow evidence of consistent terms if they "might naturally" have been included in the writing by reasonable people, the Code would bar these terms only if they "would certainly" have been included in the document. But the Code does not go as far in allowing the jury to consider additional terms as Corbin does; Corbin would look to the "actual intention" of the parties, not to whether reasonable people "would certainly" have included the terms in the document. See Murray, p. 235.

C. **Deciding whether a writing is an integration, and whether particular terms contradict or supplement it:** In the summary of the Corbin, Williston, and UCC views on how the judge applies the parol evidence rule, we have focused on the chief area of controversy, i.e., how the judge determines whether a writing which has already been decided to be an integration (i.e., a final expression of agreement) is

"partial" or "total." This issue is most often the critical one in parol evidence disputes, since frequently the oral agreement sought to be shown does not contradict the writing, but supplements it. But the judge will also have to decide:

□ whether the writing is in fact a ***final expression*** (i.e., an integration), and

□ whether the oral terms sought to be introduced ***contradict*** or, rather, ***supplement***, the writing.

All authorities agree that these decisions are to be made ***exclusively by the judge.***

Quiz Yourself on
THE ROLES OF THE JUDGE AND JURY

48. Marshall and Blackstone have a written contract whereby Blackstone will sell Marshall 10,000 "Scales of Justice" candy dishes. Marshall subsequently sues Blackstone, alleging breach of what Marshall says was an express oral warranty by Blackstone that the dishes would appreciate in value by 30% in the first year, and that if they did not, Marshall could return them.

(A) Marshall wishes to demonstrate that both he and Blackstone regarded the written contract as covering only some aspects of their deal, and that warranties were not one of the aspects intended to be covered by the writing. May Marshall, consistent with the parol evidence rule, testify to this effect, for purposes of showing that the writing is not a total integration?

(B) Assume this is a jury trial. Further assume, for this part only, that the evidence in Part A is admissible. Who (judge or jury) will decide each of the following issues: (i) whether the writing is a "final" integration; (ii) whether the writing is a "total" integration (in which case it cannot even be supplemented by prior or contemporaneous oral agreements); and (iii) whether the oral warranty that Marshall is alleging supplements, or instead contradicts, the writing?

Answer

48. A. Yes. The parol evidence rule only forbids introduction of prior agreements or contemporaneous oral agreements that vary, modify or contradict a "totally integrated" contract — one intended by the parties to be the final and complete expression of their agreement. Therefore, evidence that the writing was not intended to be a total integration is always admissible on this threshold issue that determines whether and how the parol evidence rule will apply.

B. The judge will decide all of these issues. All of these issues are viewed as being essentially procedural ones that involve primarily legal reasoning. Therefore, all are unsuitable for the jury. The jury will consequently be left with at most the job of determining whether Blackstone made the alleged oral warranty, and whether the goods breached that warranty. (The jury won't even get to decide these issues unless the judge first decides either that the integration was not total, or that it was total but that the alleged warranty only supplements the writing).

IV. SITUATIONS IN WHICH THE PAROL EVIDENCE RULE DOES NOT APPLY

A. Rule does not bar a showing of fraud, mistake or other voidability: Even if a writing is a complete integration, a party may always introduce evidence of earlier oral agreements to show ***illegality, fraud, duress, mistake, lack of consideration***, or any other fact that would make the contract void or voidable. In other words, the parol evidence rule never prevents the introduction of evidence that would show that ***no valid contract exists*** or that the contract is ***voidable.*** C&P, p. 140; Farnsworth, p. 439.

> **Example:** After numerous meetings and discussions, Buyer buys an apartment building from Seller. The contract of sale contains a standard "merger" clause (see *supra*, p. 182) reciting that the contract constitutes the sole agreement between the parties. Buyer later discovers that Seller has lied about the profitability of the property, and sues to rescind the deal. The parol evidence rule will not prevent Buyer from showing that Seller made fraudulent misrepresentations to induce him to enter into the contract.

1. Specific disclaimer of representations: Where the contract contains only a general merger clause, as in the above example, all courts

agree that the clause does not prevent a showing of fraud, mistake, or other act that would make the contract void or voidable. But suppose the contract instead contains a very specific statement that no representations of a ***particular sort*** have been made. For instance, suppose that the contract of sale in the above example provided that "Buyer has made his own inspection of the property, and no representations that may have been made by Seller concerning the condition or profitability of the premises have been relied upon by Buyer or are part of this agreement." Does such a clause change the outcome?

a. Majority view: Even where this kind of specific disclaimer is present, most courts will allow a party to show that the other party intentionally and falsely made the claims or misrepresentations covered by the disclaimer. That is, even such a specific clause will not be enough to trigger the parol evidence rule.

B. Existence of a condition: The parties may orally agree that the contract shall not ***come into existence*** until a particular event occurs. Or, they may agree that ***performance*** by one or both of them will ***not become due*** until a particular event occurs. In either case, they have imposed a ***condition***; in the first case, they have made the contract's very existence conditional, and in the second, they have made the duty of performance conditional. If the parties then sign a writing which does not include the condition that was orally agreed to, almost all courts ***allow proof of this condition*** despite the parol evidence rule.

1. Justification: Many courts, and the Second Restatement, justify this position on the grounds that the very existence of the condition shows that the writing was not completely integrated, and the condition only supplements, rather than contradicts, the writing. See Rest. 2d, § 217. (These courts would presumably not allow oral evidence of a condition that was clearly inconsistent with the writing.) See C&P, p. 142.

> **Example:** *A* and *B* agree that *A* will sell a patent to *B* for $10,000 if *C*, an engineer advising *B*, approves. *A* and *B* sign a written agreement that appears to be complete, except that the contract does not mention *C*'s approval; as they sign the contract, *A* and *B* both agree orally that it will take effect only if *C* approves. Virtually all courts would ***allow B to prove that the oral agreement was in fact made.*** Some courts would hold that this proof demonstrated that *C*'s approval was a condition to

the formation of the contract; others (and the Second Restatement) would hold that proof of the necessity of *C*'s approval would not prevent the contract from existing, but would make *B*'s duty to perform conditional on that approval. See Rest. 2d, § 217, Illustr. 1.

If, however, the written contract contained a statement that "no approval of any third person shall be necessary for the activation of any duty under this contract," evidence of the oral agreement would probably not be admissible (except to show fraud or mistake).

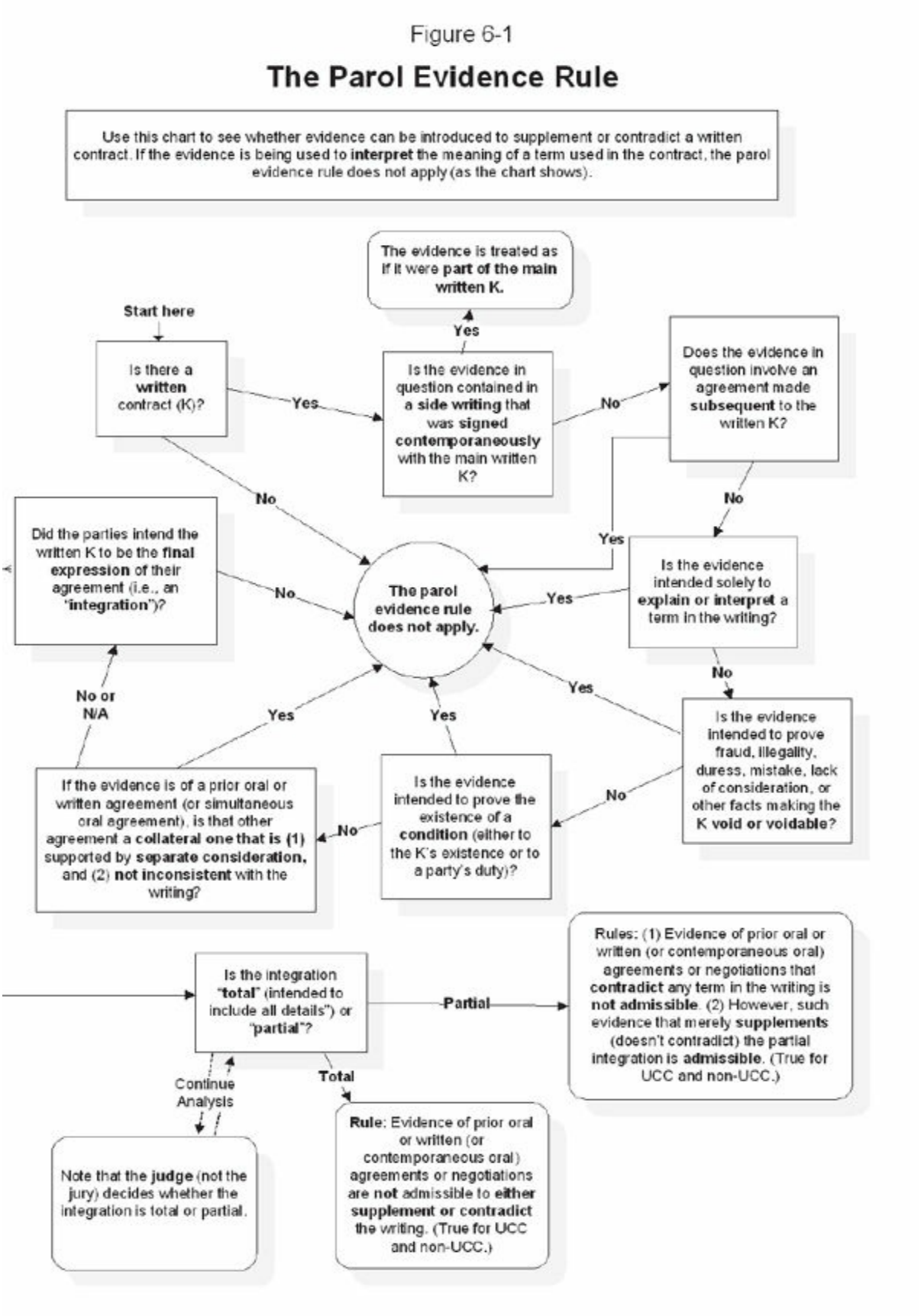
C. Collateral agreement supported by separate consideration: An oral agreement that is ***collateral*** to the main agreement, and that is supported by ***separate consideration,*** may be demonstrated, even though it occurred prior to what seems to be a completely integrated writing.

Example: *A* and *B*, in an integrated writing, promise that *A* will sell a specific automobile to *B*. As part of the transaction, the two orally agree that *B* may keep the car in *A*'s garage for the next year, at a rent of $50 per month. This oral agreement may be proved despite the parol evidence rule, since it was supported by separate consideration, the $50 per month charge, and since it's not inconsistent with the writing. Cf. Rest. 2d, § 216, Illustr. 3.

1. Not inconsistent with total integration: However, if the writing is a total integration, the separate agreement must not be ***directly inconsistent*** with the writing.

Figure 6-1

The Parol Evidence Rule



Example: Same facts as above example. Assume the writing has a merger clause, saying that there are no other agreements between the parties regarding the automobile transaction. Suppose further that the writing says, "*B* shall have no right to keep the car in *A*'s garage at any time." *B* will not be allowed to prove the alleged oral agreement, since that agreement is directly inconsistent with the writing, and the writing is a total integration.

D. Subsequent transactions: As we said earlier, the parol evidence rule never bars evidence that ***after the signing of the writing***, the parties orally or in writing agreed to modify it or rescind it. In other words, the parol evidence rule bars only evidence of transactions that occurred prior to (or in some cases contemporaneously with — *supra*, p. 177), the writing.

E. Interpretation: The parol evidence rule does not bar extrinsic evidence when offered to aid in the ***interpretation*** to be given to an ***ambiguous term*** of the contract. This rule is discussed extensively in the next section, "Interpretation," beginning on p. 188 *infra*.

Quiz Yourself on
WHEN THE PAROL EVIDENCE RULE DOES NOT APPLY

49. Enrico Fermi patents a new invention: a solar-powered flashlight. He enters into a written agreement to sell the patent to Albert Einstein. The parties orally agree that the contract will not become effective until the patent is reviewed and approved by a patent expert, Moe Howard, of the patent law firm Larry, Moe, and Curly Joe, P.C. Howard reviews the patent and tells Einstein, "It's bogus. Only a stooge would buy this." Fermi sues Einstein, seeking to enforce the contract. Einstein wants to introduce evidence of the oral condition. Will the parol evidence rule prevent him from doing so?

50. Gary Gullible enters into a contract with Sam Slick, owner of the "Better than New" used car lot, for the purchase of a used car. While examining the car, Gary asks Sam if it had ever been in any accidents. Sam says, "Absolutely not. This car is in the same condition it was in the day it left the assembly line." On the sales contract, Gary is required to initial a clause stating as follows:

"Buyer has had an opportunity to inspect this vehicle and to satisfy himself of its

condition prior to the purchase. Buyer accepts this vehicle in its current condition. Buyer is not relying in any way on any oral representations concerning the vehicle's condition that may have been made by Seller."

A few months later, during a routine service, a mechanic points out some obvious repair work indicating the car has been in a major accident sometime in the past. Gary sues to have the contract rescinded. At trial, may Gary enter evidence that Sam knowingly lied about the accident issue?

Answers

49. No. The parol evidence rule only operates when a contract is *effective*. This means that anything showing it's *not* effective — fraud, a lack of consideration, duress, mistake, or, as here, failure of a condition to the contract's effectiveness — *is* admissible. Here, the allegation is that the agreement is only binding if Howard approves the patent. If true, this would be a condition to the contract's effectiveness, so Einstein *can* introduce evidence to prove the condition was agreed upon.

50. Yes. Even though the disclaimer states that Buyer assumed the risk of the car's condition and that Seller made no oral representations, Gary will be able to introduce evidence of his conversation with Sam during the negotiations for the sale. The parol evidence rule does not bar evidence designed to prove fraud, such as that the other party ***intentionally misrepresented*** an aspect of the deal otherwise covered by a disclaimer clause.

V. INTERPRETATION

A. Interpretation generally: The parol evidence rule deals with whether and when the parties to a written contract may use evidence of a prior oral or written agreement to add new, substantive terms that either contradict or supplement the writing. We turn now to a different, but related problem — how the parties may show the ***meaning*** of terms contained in a writing. This is a problem of interpretation. That is, the parties seek not to introduce new terms that are not contained in the writing, but to ***interpret the meaning of the terms*** which are contained in the writing.

1. The problem generally: When the parties are in dispute about what *meaning* is to be attached to terms used in the contract, problems

relating to extrinsic evidence arise just as they do in the contexts dealt with by the parole evidence rule. That is, one party will frequently argue that the meaning of the term is perfectly apparent without resort to any evidence other than the document itself, whereas the other party will argue that the term is ambiguous, and can only be interpreted by resort to evidence beyond the document.

Therefore, we need to understand the "rules of the road," that is, the procedures by which the court goes about deciding (1) whether to admit any extrinsic evidence concerning interpretation; (2) who should hear that extrinsic evidence if it is to be allowed; and (3) which types of extrinsic evidence should be allowed. As it turns out, courts are in nearly perfect agreement as to some of the relevant rules, but in sharp disagreement as to others.

2. **Extrinsic evidence in the case of ambiguous terms:** ***All courts agree*** that if a term is found by the trial court to be ***ambiguous*** — capable of more than one meaning — ***extrinsic evidence must be allowed***. Furthermore, courts are in near-universal agreement that this extrinsic evidence is to be ***evaluated by the jury***, not by the judge. Finally, courts are in unanimous agreement that the types of extrinsic evidence that are to be allowed to help resolve the meaning of the ambiguous term are ***extremely broad***. In particular, courts agree that evidence about what the parties' own ***pre-contract negotiations*** indicated to be the meaning of the ambiguous term is to be ***admitted***, and heard by the jury.

   Example: Suppose that Buyer contracts to buy a business from Seller, and that part of the purchase price is to be a particular percentage of the "Gross Profit" earned by the business in the year after acquisition. Assume further that within the document itself there is no attempt to define "Gross Profit," perhaps because the parties believe that this term is unambiguous. A dispute breaks out about how gross profit is to be measured, and Seller sues Buyer. Assume for the moment that the trial court determines that the term "Gross Profit" is ambiguous. (Let's not worry for now about how the trial court comes to this determination. As we'll see in a moment, this question "How does the trial court determine whether there is ambiguity?" is actually the most controversial question in this whole area.)

   Virtually all courts agree that once the term is found by the trial judge to be ambiguous, ***it is up to the jury***, not the judge, to decide on the meaning of this term. Virtually all courts further agree that a ***wide range of extrinsic evidence*** should be allowed to be presented to the jury on the meaning of the term "Gross Profits." Now, suppose that Seller wants to present the jury testimony by Seller that while the parties were negotiating the transaction, Buyer said to Seller, "We'll compute 'Gross Profits' the way your accountant has always done, in the financial statements that your accountant has prepared for the business in past years." Even though this type of extrinsic evidence — evidence about what the parties said

during their negotiations — is the most troublesome kind of extrinsic evidence, virtually all courts will ***allow*** the jury to hear it, because the judge has already made the threshold determination that the term is ambiguous and its meaning is to be decided by the jury.

a. **Course of dealing and course of performance:** Where a term used in the writing is ambiguous, courts also allow evidence of ***trade usage, course of dealing and course of performance*** to show what the ambiguous term was intended to mean. This topic is explained in detail *infra*, p. 192.

3. **Unambiguous terms:** Now, let's suppose that the trial judge decides that the term in question is completely ***unambiguous***. (Again, let's put aside the very controversial issue of how the judge is to make this determination.) Here, too, courts are in virtual unanimity about what happens next. Since the term is unambiguous, it is ***for the judge***, not the jury, to ***say what the term means***. Consequently, the jury will be instructed by the judge on the term's meaning, and the jury will never hear any sort of extrinsic evidence about what the term means.

4. **How judge determines existence of ambiguity:** The principal "fighting issue" — the issue on which courts disagree — is ***how the judge should decide whether the term is ambiguous***. On this controversial issue, there are three main approaches, which we will term: (1) the ***"four corners"*** rule; (2) the ***"plain meaning"*** rule; and (3) the ***"liberal"*** rule.

   a. **The "four corners" rule:** The ***"four corners"*** rule is the most stringent of the three. Under this approach, when the judge decides whether the term is ambiguous, the judge ***may not consult any extrinsic evidence whatsoever.*** That is, the existence of ambiguity is to be determined ***solely by looking within the "four corners" of the contract itself.*** Thus not only will the court not consider evidence about the parties' negotiations, it will not even consider evidence about the context surrounding the making of the agreement. This hyper-strict rule is followed by relatively few courts.

   b. **The "plain meaning" rule:** The ***"plain meaning"*** rule or approach, as it is generally applied, is in the ***middle*** of the three approaches in terms of strictness. The most significant aspect of the

plain meaning rule is that when the court goes to decide whether a term used in the agreement is ambiguous, the court ***will not hear evidence about the parties' preliminary negotiations.*** (However, the court *will* hear evidence about the circumstances, or ***"context,"*** surrounding the making of the agreement.) Farnsworth, § 7.12, pp. 477-478.

c. The "liberal" rule: Finally, what might be called the ***"liberal"*** rule rejects — or at least significantly weakens — the plain meaning approach. Under the liberal view, "***evidence of prior negotiations*** is ***admissible*** ... for the limited purpose of enabling the trial judge to determine whether the language in dispute lacks the acquired degree of clarity." Farnsworth, § 7.12, pp. 479-80. The Second Restatement seems to take this view; the Comments say that "determination of meaning or ambiguity should only be made in light of the ... preliminary negotiations." Rest. 2d § 212, Comment b. The most famous case applying the liberal view — and thus allowing the judge to look to the parties' ***pre-signing negotiations*** to determine whether a contract term is ambiguous — is set forth in the following example.

> **Example:** D contracts to do some repair work on P's steam turbine. In the contract, D promises to indemnify P "against all loss, damage, expense and liability resulting from…injury to property, arising out of or in any way connected with the performance of this contract." During the work, the turbine is damaged. D seeks to argue that by this clause, the parties meant for D to pay only for damage to the property of third persons, not for damage to P's own property.
>
> *Held*, D has the right to attempt to prove, by oral testimony, that this was what the parties intended. The trial judge was incorrect in applying the plain-meaning rule, i.e., in looking solely at the document itself and in concluding that by its "plain language" the document required D to pay for injuries to P's property. "A rule that would limit the determination of the meaning of a written instrument to its four-corners merely because it seems to the court to be clear and unambiguous, would either deny the relevance of the intention of the parties or presuppose a degree of verbal precision and stability our language has not attained." Before allowing D to put on extensive testimony, however, the trial judge should first make a preliminary review to ascertain whether the contract was at least "fairly susceptible" of D's interpretation. *Pacific Gas & Electric Co. v. G. W. Thomas Drayage & Rigging Co.*, 442 P.2d 641 (Cal. 1968).

i. **Limitations on liberal view:** The liberal view runs the risk of significantly ***weakening the parole evidence rule***, by giving a litigant a chance to use the parties' pre-contract statements to

prove that "The contract doesn't mean what it seems to mean." Courts following the liberal approach are aware of this danger. Consequently, they take pains to ensure that the evidence of prior negotiations is admissible only for the purpose of "interpreting," not "contradicting," the writing. Where, then, is the dividing line between interpretation and contradiction? "Interpretation ends with the resolution of problems that derive from the failure of language, that is to say, with the resolution of ***ambiguity*** and ***vagueness***. Accordingly, even under the liberal view, extrinsic evidence is admissible [while the judge is deciding whether the document is ambiguous] only where it is relevant to ambiguity or vagueness ***rather than inaccuracy or incompleteness***." Farnsworth, § 7.12, p. 480.

5. **Burden of persuasion:** A party who is allowed to give testimony about what the parties intended by a term will still have problems of proof. If he is the plaintiff, his burden of persuading the court that the meaning favorable to him was ***in fact the one intended by the parties*** may be substantial.

Example: D, an American corporation, agrees to export to P, a Swiss corporation, a certain quantity of eviscerated "chickens." D ships "stewing" chickens (older, heavier birds), which P rejects, claiming that the contract contemplated young "broilers" or "fryers." P argues that there is a trade usage by which "chicken" means "young chicken."

Held, P has failed to sustain its burden of showing that the stewing chickens are not "chicken." Trade usage is binding on D only if it had "actual knowledge" of the usage, or the usage is "so generally known in the community that [D's] actual individual knowledge of it may be inferred." Here, D was quite new to the poultry business, and P did not prove that the alleged trade usage was sufficiently well established; on the contrary, its witnesses testified that they were careful to say specifically "broilers," rather than merely "chicken," when they wanted young chickens. Furthermore, U.S. Department of Agriculture regulations in force at the time included "stewing chickens" among the various classes of "chickens." D was entitled to use the meaning included in these regulations, particularly since P's first inquiry referred to "grade A government-inspected" chickens, as did the contract.

Since D has proved that its subjective understanding of the word "chicken" (i.e., "stewing" chickens) coincided with at least one objective meaning of that word (as shown by the government regulations and by the realities of the marketplace, among other factors), P has not sustained the burden of showing that both parties intended only the narrower use of the word. *Frigaliment Importing Co. v. B.N.S. International Sales Corp.*, 190 F.Supp. 116 (S.D.N.Y. 1960).

B. Maxims of interpretation: There are a number of frequently cited "maxims" that courts make use of in deciding which of two conflicting interpretations of a term should be followed. Several of the best-known of these are as follows:

1. **Primary purpose rule:** If the ***"primary purpose"*** of the parties in making the contract can be ascertained, that purpose is given "great weight." Rest. 2d, § 202(1).

2. **All terms made reasonable, lawful and effective:** All terms will be interpreted, where possible, so that they will have a ***reasonable, lawful and effective meaning***. Rest. 2d, § 203(a).

3. **Construction against the draftsman:** An ambiguous term will be ***construed against the drafter***. Rest. 2d, § 206.

4. **Negotiated terms control standard terms:** A term that has been ***negotiated*** between the parties will control over a standardized portion of the agreement (i.e., the fine print "boilerplate") that is not separately negotiated. Rest. 2d, § 203(d).

   a. **Typewritten or handwritten words:** This will usually mean that a clause that has been ***typewritten*** in as a "rider" to a pre-printed form contract, or a clause that has been ***handwritten*** onto a typewritten agreement, will have ***priority*** in case of a conflict.

C. One party knows or should know of the other's meaning: Where the parties ***attach different meanings to a particular term,*** some special rules of interpretation apply:

□ If one party ***knows*** (or has ***reason to know***) that the two parties attach different meanings to the term, and the other ***does not know or have reason to know*** this, then the meaning given by the latter ***("innocent") party controls***;

□ If ***neither*** party ***knows or should know*** that the two parties attach different meanings to the term, then ***neither party is bound*** by the other's meaning. In that case, the court will ***supply a reasonable value*** for the unagreed-upon term.

See Rest. 2d, §§ 201(2) and (3).

Example: Contractor agrees to paint Owner's house for a fixed price. Owner specifies "Enamel" paint of a certain color. Contractor intends to use a relatively low-durability

and inexpensive paint known as "Enamel" in the painting trade. Contractor has reason to know that Owner has in mind a higher-quality paint known among wealthy homeowners as "Enamel." Owner neither knows nor has reason to know that the two parties have different understandings of "Enamel." A contract exists for the type of "Enamel" as understood by Owner (the high-quality one).

On the other hand, if *neither* party knew or had reason to know of the misunderstanding, neither would be bound to the other's meaning. If the disagreement was so major (and on such an essential point) that it prevented there from being a meeting of the minds entirely, a court would probably find that no contract at all was formed. But if the disagreement was not so major, a court would supply a "reasonable" meaning for the disputed "Enamel" term.

VI. TRADE USAGE, COURSE OF PERFORMANCE, AND COURSE OF DEALING

A. Common-law use of "custom": Words and phrases frequently have more than one meaning. The meaning of a particular word or phrase may vary from one region of the country to another, from one industry to another, etc. At common law, a party who argued that a particular meaning should be used could show that this meaning was in accord with a ***"custom,"*** or traditional usage. However, he was allowed to introduce evidence of a particular custom only if it met a stringent series of requirements, including that it be "lawful," "reasonable," "notorious," "universal," "ancient," etc. Murray, p. 255.

B. Modern tendency exemplified by UCC: The modern tendency is to allow a party ***much more leeway in showing*** that a particular meaning is in accord with custom or usage. Furthermore, the tendency is to distinguish between broad customs, such as customs existing throughout a particular industry, and narrower customs, such as those historically in existence between two particular contracting parties. We will focus here on the treatment of custom in the UCC.

1. Three sources of meaning in the UCC: The UCC recognizes three different sources which may be used in interpreting the terms of a contract: ***course of performance, course of dealing***, and ***usage of trade***.

a. Course of performance: A "course of performance" refers to the way the parties have conducted themselves in performing ***the particular contract at hand***. If, for instance, the contract calls for repeated deliveries of "highest grade oil," evidence as to the quality

of oil delivered and accepted in the first installments would be admissible as a course of performance to help determine whether oil delivered in a later installment met the contract's standards. The idea is that the parties' own actions in performing the contract supply evidence as to what they intended the contract terms to mean. UCC § 1-303(a).

b. Course of dealing: A "course of dealing" is also a pattern of performance between the two parties to the contract, but it refers to how they have acted with respect to ***past contracts***, not with respect to the contract in question. Thus if a particular term had been used in previous contracts between the same parties, and had been interpreted by them in a certain manner, this interpretation would be admissible to show how the term should be interpreted in the current contract. § 1-303(b).

c. Usage of trade: The Code defines a ***"usage of trade"*** as "any practice or method of dealing having such ***regularity of observance*** in a ***place, vocation or trade*** as to justify an expectation that it will be observed with respect to the transaction in question." § 1-303(c). Thus the meaning attached to a particular term in a certain region, or in a certain industry, would be admissible.

> **Example:** Customer orders 1,000 letterheads from Printer. Assume that it is a custom in the printing industry that where a particular quantity is ordered, any variation by the printer from that quantity is acceptable as long as it is not greater than 5% above or below it. If Printer delivers 960 letterheads, she will normally be able to introduce this custom as a "trade usage." (However, Printer will have to show that the custom is so regularly observed in the industry as to ***"justify an expectation that it will be observed*** with respect to the transaction in question" — § 1-303(c). But Printer doesn't have to show that Customer *actually* knew of the trade usage, merely that Customer *should* have known of it, due to its regular observation in the industry.)

C. Effect on the parol evidence rule: The greatest significance of course of dealing, course of performance, and usage of trade, is that these customs may be introduced to help interpret the meaning of a writing ***even if it is a complete integration***. § 2-202(a). These sources are thus not affected by the parol evidence rule, which as we have seen ordinarily bars even evidence of "consistent additional terms" where a complete integration exists. In other words, even though a writing is found to be the final and exclusive embodiment of the agreement, it may still be

explained by evidence from these three sources.

1. **Customs that are "carefully negated":** The writing may, however, bar introduction even of course of dealing, course of performance and trade usage, if these sources are ***"carefully negated"*** during the negotiation. Comment 2 to § 2-202.

   > **Example:** Same facts as above example (Customer orders 1,000 letterheads from Printer, and receives 960). Despite the existence of a "trade usage" permitting 5% variation either way, if Customer can show that either in his purchase order or orally he indicated to Printer that he needed precisely 1,000 to do a mailing to 1,000 people, the trade usage will not be binding on him.

D. Allowable to add or subtract from the agreement: Course of dealing and of performance and trade usage are admissible not only to help interpret a particular phrase, but also actually to ***add or subtract terms*** to or from the contract. Thus § 2-202, the basic parol evidence rule, states that these sources may not only explain but ***"supplement"*** a writing, even a complete integration. For instance, a particular warranty may be implied through course of dealing or usage of trade (§ 2-314(3)), and a requirement that one party notify the other in certain circumstances (e.g., the termination of an at-will contract) might also be supplied through these sources. See Murray, p. 253.

1. **Contradiction of express term under the UCC:** The UCC states that course of dealing, course of performance and trade usage may not be used to ***contradict*** the express terms of a contract — § 1-303(e) provides that these items must be construed as consistent with the express terms wherever it is reasonable to do, and then goes on to say that "if such a construction is unreasonable, ***express terms prevail over course of performance"*** and "***course of performance prevails over course of dealing and usage of trade***[.]"

   a. **Consequence:** So if the court concludes that there is no way to harmonize, say, a trade usage asserted by one of the parties with an express provision of the contract, the court ***must treat the express term as controlling.***

   b. **Chipping away at express term:** However, some courts have gone to great lengths in order to find that a particular custom or usage merely "***supplemented***," and did not "contradict," an express contractual term. One way courts do this to hold that the custom or

usage merely removes ***part*** of the express term, rather than negating that express term completely. So long as the custom or usage does not wholly swallow up the express term, the court may find that the two can be reasonably construed to co-exist.

> **Example:** Seller contracts to sell asphalt to Buyer under a long-term supply contract. The written contract provides that the price will be "[Seller's] Posted Price at time of delivery." After the contract has been in force for several years, the market price of asphalt increases dramatically. On December 31, 1973, Seller raises its price by 75%, effective January 1, 1974. Seller refuses to give Buyer any "price protection;" that is, Seller refuses to keep the lower price even for quantities ordered by Buyer prior to December 31 but to be shipped after January 1. (Seller has granted Buyer several months of price protection on two prior occasions.) Buyer sues Seller for breach, arguing that the trade usage granting reasonable "price protection" should be deemed part of the contract, and thus breached by Seller.
>
> *Held*, for Buyer. The price increase asserted by Seller, effective on one day's notice, did indeed match the express price term in the written contract ("Posted Price at time of delivery"). But the custom of "price protection," adequately proven by Buyer to be a trade usage in the local asphalt industry, can be construed consistently with this express price term. This is because the price protection trade usage "forms a broad and important exception to the express term, but ***does not swallow it entirely,***" and exceptions will be allowed if they don't totally negate the express term. Therefore, a reasonable jury could have found that the price protection, as a trade usage, was incorporated into the written agreement. (By contrast, a trade usage that Buyer was to set the price would be a "total negation" of the express term, and would therefore have to be rejected in favor of the express term.) *Nanakuli Paving & Rock Co. v. Shell Oil Co., Inc.*, 664 F.2d 772 (9th Cir. 1981).

E. Priorities: In a particular case, it may happen that course of dealing, course of performance, and/or trade usage, are inconsistent with one another. As we noted above, the Code resolves this problem by stating that the ***most specific pattern controls***. Thus an ***express contractual provision*** controls over a ***course of performance***, which controls over a ***course of dealing***, which controls over a ***trade usage***. § 1-303(e).

VII. OMITTED TERMS SUPPLIED BY COURT

A. Court may supply term: In the discussion of "indefiniteness" of the contract (*supra*, p. 67), we saw that where the offer and acceptance together are not completely definite as to all essential terms, the modern tendency is for courts to ***supply the missing terms*** in many situations, at least if it is apparent that the parties wanted to bind themselves. For instance, the UCC allows the court to supply a reasonable price (§ 2-

305(1)); a place for delivery (§ 2-308); a time for shipment or delivery (§ 2-309(1)); and a time for payment (§ 2-310(a)).

1. **Relation to interpretation:** This process of supplying missing terms is obviously related to the process of "interpretation," discussed previously. However, interpretation is merely the art of construing what the parties ***actually meant*** by the words they used; when the court supplies missing terms, it is almost always dealing with questions that the parties never even thought of, and consequently did not address in the contract. Since courts have traditionally not liked to admit that they are "making a contract for the parties," they often disguise this process by stating that they are merely interpreting the parties' intent.

B. Restatement rule: The increased willingness of modern courts to supply missing terms, and admit that they are doing so, can be seen by one of the relatively few sections in the Second Restatement that has no counterpart in the First Restatement; Rest. 2d, § 204 provides that: "When the parties to a bargain sufficiently defined to be a contract have not agreed with respect to a term which is ***essential*** to a determination of their rights and duties, ***a term which is reasonable in the circumstances is supplied by the court."***

1. **Duty of "good faith":** One of the terms most frequently supplied by the courts is a ***"duty of good faith."*** For instance, in *Wood v. Lucy Lady Duff-Gordon*, *supra*, p. 114, the court supplied a requirement that the plaintiff make good-faith, reasonable, efforts to promote the defendant's fashion creations. Similarly, in requirements and output contracts, UCC § 2-306(1) expressly limits the contract to "such actual output or requirements as may occur in good faith.…" See the more extensive discussion of the duty of good faith *supra*, pp. 69-70.

2. **Duty to continue business:** One common situation in which courts have occasion to supply an omitted duty arises where one party is to derive benefits from the other's conducting of a business. A requirements contract is one example of such a contract; agreements providing for payment of royalties based upon the number of units sold constitute another example. In this situation, may the one party defeat the other's economic expectations by ***going out of business***

(e.g., failing to have any further "requirements," or to pay any royalties because there are no more sales)? It is impossible to state a general rule applicable to these situations. However, we can say this:

a. Requirements and output contracts: Generally no obligation to continue in business will be found in ***requirement and output*** contracts. However, the previously-referred-to duty of ***good faith*** will prevent one party from sabotaging the other by changing the product required or produced just enough to escape from the contract, or by making decisions that appear to be based solely on the desire to get out of the contract, or doing anything else that strikes the court as being unfair. C&P, p. 215.

i. **UCC view:** The UCC deals explicitly with the going-out-of-business problem with respect to requirements contracts. Official Comment 2 to § 2-306 states: "Reasonable elasticity in the requirements is expressly envisaged by this Section and good-faith variation from prior requirements are permitted even when the variation may be such as to result in ***discontinuance***. A shut-down by a requirements buyer for lack of orders might be permissible when a shut-down merely to curtail losses would not. The central test is whether the party is acting in good faith." (Apparently the same rule applies for output contracts, though the Comment does not explicitly so state.)

ii. **Severity of loss:** One factor useful in distinguishing between a shutdown that is in "good faith" and one that is not is the ***severity*** of the financial hardship leading to the shut-down. The more severe the losses to the party from continuing in the business, the more likely it is that his shut-down will be found to be in good faith. A lack of profit, or even a small financial loss, will not usually be enough to entitle a party to a requirements or output contract to change his business in a way that eliminates the requirements or output.

3. Limits on competing with other party: Where one party distributes a product on which the other is to receive ***royalties***, at least some limits will be placed on the former's right to ***carry competing***

products. If at the time of the contract the parties contemplated that there would not be such competition, it will not later be allowed if the purpose or principal effect is to diminish the royalty payments.

   a. **Effect of substantial minimum payment:** If, in addition to a royalty or other profit-sharing arrangement, one party makes a ***substantial minimum payment*** to the other for use of a product or facility, the court is less likely to prevent the former from selling a competing product, going out of the business that is producing the royalties, or otherwise hurting the latter's financial interest.

4. **Termination of dealership or franchise:** One situation in which the court is frequently asked to imply a term is where one party holds a ***franchise*** or ***dealership*** for another's products, and the latter exercises a right, recited in the contract, to ***terminate*** the arrangement without cause. When this happens, the dealer or franchisee commonly asserts the existence of an implied duty on the part of the franchisor/manufacturer not to terminate without cause, and to provide reasonable notice prior to termination.

   a. **Implied term:** Courts have become substantially more willing to find such an implied duty in recent years. See e.g., *Shell Oil Co. v. Marinello*, 307 A.2d 598 (N.J. 1973), enjoining Shell from cancelling a gas station dealership without cause, even though the contract explicitly allowed such termination. But many courts still refuse to override an express contractual provision allowing for termination without cause.

   b. **Reasonable notice:** Some courts have followed a "middle ground." They allow termination without cause, but they find an implied requirement of a ***reasonable period of notice*** prior to the termination.

5. **Termination of employment contract:** The court will sometimes have to supply a missing term in deciding whether and when an employer may ***terminate an employment agreement***. In many employment relationships, the parties do not expressly set the terms under which the agreement can be terminated. Therefore, two questions arise: (1) What termination provision should be implied? and (2) If the agreement is to be treated as "at will" (whether by

implication or because it is expressly so made), should there be an exception implied to prevent the employer from a ***bad faith*** termination? We consider each of these questions in turn.

a. At-will clause generally implied: In a normal employment situation, especially one where the arrangement is not reduced to a writing, the parties often do not specify the term of the agreement, or the circumstances under which it could be terminated. Typically, the employer simply offers the applicant a job, and the employee accepts by coming to work. In this ambiguous situation, courts almost invariably supply an ***"at will"*** term. That is, courts almost always presume that the parties intended for either to be able to terminate the arrangement on no or virtually no notice.

i. **"Permanent" job:** This is true even where the job is described as a ***"permanent"*** one — the court will still presume (in the absence of proof to the contrary) that the parties intended that either party could terminate at will. See Farnsworth, p. 513.

b. Traditional rule allows untrammeled termination: Assume, now, that the arrangement is at-will (either because the parties have expressly defined their arrangement as being at-will, or because the court has implied an at will term from an arrangement that is silent on the issue of termination). In this common situation, courts have traditionally held that the at-will arrangement may be terminated by either party ***for no reason at all***, or even ***for a bad faith reason***. In other words, courts have traditionally interpreted the "at will" concept very literally.

c. Emerging trend toward requiring good faith: But a ***significant minority*** of courts has, in the last 30 or so years, ***modified*** this traditional rule. According to this emerging minority, even in an ostensibly at-will employment relationship, the employer is not permitted to ***terminate the arrangement in bad faith***. Some of the particular motives on the employer's part that may give rise to liability for bad-faith firing have been:

□ intent to deprive the employee of a ***pension*** for which she will soon qualify;

□ intent to retaliate because the employee ***refused to commit***

wrongdoing at the employer's urging, or because the employee ***refused to keep silent about wrongdoing committed by others*** (the so-called ***"whistle-blower"*** scenario); or

□ intent to retaliate for the employee's filing of a worker's compensation, sex-discrimination or other ***statutory claim***.

See Farnsworth, pp. 514-15.

i. **Clause requiring good faith supplied as a matter of law:** Of the minority of courts imposing on the employer a duty to refrain from bad-faith firings, some impose this duty as a matter of ***law,*** i.e., without regard to the actual intent of the parties.

ii. **Implied-in-fact clause requiring good faith:** Other courts rejecting the unrestricted at-will-employment theory review the particular contract to determine whether there is an ***"implied-in-fact"*** clause prohibiting bad faith terminations. According to this group of courts, even if the written employment contract appears to be at will, ***oral statements*** made by the employer, ***personnel manuals***, company practices, or other dealings by the employer may ***create a justified understanding on the part of the employee*** that he will not be fired except for reasonable cause. In this situation, the court is (at least in theory) simply construing the contract, rather than imposing its own limitation on firing.

iii. **Tort cause of action:** Of those courts that give the plaintiff a cause of action for bad-faith discharge, not all do so on the basis of contract law. Some courts have defined a ***tort*** of ***wrongful discharge***. When courts have defined such a tort, they have generally done so in situations where the employee was fired for reasons that ***violate public policy.*** Common examples are the retaliatory firings of employees who are ***"whistle-blowers,"*** or who ***refuse to participate in illegal actions demanded by the employer.***

6. **Relation to parol evidence rule:** The court is free to supply a "reasonable" omitted term ***even if the contract is a completely integrated one*** (i.e., one to which, under the parol evidence rule, not

even consistent additional terms may be added). In this situation, evidence of the parties' prior negotiations or oral agreements may be given as evidence of what is "reasonable," but may ***not*** be given for the purpose of ***supplying the omitted term itself.*** In other words, it is the court's judgment as to reasonableness, not the parties' prior negotiations, that determines whether the missing term is to be added.

Quiz Yourself on
INTERPRETATION; TRADE USAGE, COURSE OF PERFORMANCE, AND COURSE OF DEALING; OMITTED TERMS SUPPLIED BY THE COURT

51. Wally, Eddie and Lumpy are members of a secret club. They use a secret code to help keep their communications private. As part of their code, "red" really means "blue," and "shirt" really means "sweater." Wally and Lumpy enter into a written contract whereby Wally is to sell to Lumpy his "red shirt" for $5. Wally tenders his red shirt and Lumpy sues for breach, claiming that he is supposed to get Wally's blue sweater for the $5. Under the modern view towards such matters, can Lumpy introduce evidence about the boys' secret code?

52. Shirley Dimple, child actress, enters into a deal with World Studios whereby she agrees to "dance and act" in three movies of World's choice over the next three years. Dimple makes the film, "The Good Ship Bubble Gum" in the first year, in which she not only dances and acts, but also sings. In the second year, World wants Dimple to be in "Tap Dancing Orphans," in which she is also expected to sing, dance and act. Dimple refuses, saying that her contract only obligates her to dance and act, and that she no longer wishes to sing on film. World sues for breach of contract.

(A) Dimple offers evidence that the custom in the film industry is to use the term "dance" in talent contracts only to refer to dancing, not singing and dancing. Is Dimple's evidence admissible?

(B) Assume that Dimple's evidence, offered in Part (A), is admitted. Assume further that World is permitted to show in rebuttal that in the first movie, Dimple raised no objection to singing, and did not indicate

that she was being asked to do something that her contract did not require. How should the judge instruct the jury as to the relative weight to be given to Dimple's evidence and World's rebuttal evidence?

Answers

51. Yes. Under the *traditional* view to parol evidence and interpretation, the "plain meaning" rule (which says that terms and provisions that on their face are unambiguous may not be altered by parol evidence) would apply. In that event, Lumpy Lumpy would be out of luck, since there is nothing ambiguous on its face about the term "red shirt." The modern approach, however, is to reject the plain-meaning rule, and allow testimony about what the parties intended by any term or provision, even if that term or provision, viewed solely in the context of the document's "four corners," seems unambiguous. So under the modern approach, Lumpy will be entitled to testify that he and Wally were applying their secret-code meaning to the terms, not using these terms' ordinary-language meaning.

52. (A) Yes, the evidence comes in. Even in jurisdictions that follow the "plain meaning" rule (see prior question), evidence of "course of performance" (same contract), "course of dealing" (prior contracts between same parties), and "trade usage" (industry customs) can be introduced to help in interpreting the meaning of contract terms. The evidence Dimple seeks to introduce would be considered "trade usage" evidence, and it will be allowed.

(B) That precedence should be given to World's evidence. If evidence about course of performance, course of dealing and/or usage of trade is introduced and one type of evidence contradicts another, the court will give priority to the ***most specific*** pattern. In other words, course of performance controls over both course of dealing and usage of trade, and course of dealing controls over trade usage. Therefore, World's evidence (course of performance, since all the pictures are under a single contract) will be given priority over Dimple's evidence (trade usage).

EXAM TIPS ON PAROL EVIDENCE AND INTERPRETATION

☛ **Overall rule:** Remember the standard parol evidence rule:

> Evidence of a prior (oral or written) agreement may ***never*** be admitted to ***contradict*** any ***final writing*** (integration), and may not even ***supplement*** a final writing that was intended to constitute the ***complete*** agreement (total integration).

(For more about making the distinction between partial integrations and total ones, see the last three paragraphs of these tips, on p. 201.)

☛ **Focus on exceptions:** Most exam questions involve not the standard parol evidence rule (or at least not just that rule), but situations where the rule does not apply. Look for the three most-often-tested such situations:

(1) Clarification of ambiguity: Evidence of prior or contemporaneous negotiations *is* admissible to properly ***define*** an ***ambiguous*** term, even one contained in a total integration. The ambiguity may either be apparent on the face of the contract or derive from the underlying circumstances.

Example: A written contract between *C*, a building contractor, and *S*, a carpentry sub-contractor, states that *C* agrees to "reimburse *S* for all material purchased by *S* for the job." *S* purchases $5,000 worth of lumber and only uses $3,000 worth of it. (Assume that the writing is intended as the final and complete expression of the parties' agreement.) *C* refuses to reimburse *S* for more than $3,000 worth of lumber. *S* may testify to a conversation which took place prior to the signing of the contract in which *C* agreed that he would pay for materials purchased but not actually used — this evidence will not contradict or supplement (add a term to) the agreement, it will merely aid in the interpretation of the ambiguous phrase "purchased for the job."

☞ *Hint*: Some ambiguities will only become apparent after you analyze the unique circumstances surrounding the contract. The above example is an illustration.

☞ **Can't change the meaning:** Be sure that the extrinsic evidence is truly offered for the purpose of interpreting an ambiguous clause, ***not adding or changing*** an unambiguous

one (in which case the standard parol evidence rule applies).

Example: In a contract between a laboratory and a disposal company, the disposal company agrees that "the specified waste products are to be removed from the site within 48 hours of our being notified that the waste containment vessel is 80 percent filled." On one occasion, the waste container isn't emptied until 96 hours after notification because notice was given the day before a holiday weekend. The disposal company may not show that during contract negotiations, the parties agreed that the 48-hour deadline wouldn't apply to holiday weekends. This is so because the language isn't ambiguous ("48 hours" can only have one meaning) and the evidence the company seeks to introduce would *change* rather than *clarify* the terms of the writing.

☞ Remember that ambiguities are construed against the party who prepared the contract.

(2) Custom: There are several ways in which ***"customs"*** may be introduced to interpret the meaning of a contract. When one of these ways applies, there is no parol evidence problem, because the custom is being introduced for interpretation, not in order to vary the writing. The two most frequently tested types of custom:

☞ **"Course of dealing":** This is evidence about a ***pattern of performance between the two parties under past contracts.*** (Distinguish this from "course of performance," which is how the parties have behaved under the current contract — the same rule allowing proof applies to course of performance.) Evidence of how the parties acted with respect to the past contracts may be used to show how a term in the current contract should be interpreted.

Example: *B*, a retail florist, has been ordering roses from *S*, a flower wholesaler, for more than a year. The orders are for "roses," and have always been filled with roses of assorted colors. Evidence of these past transactions can be introduced by *B* to show that when she placed her present order for "roses," she did not want (and the "contract," — i.e., the present order — didn't call for) only red roses.

☞ **"Usage of trade":** This is evidence of a ***generally accepted practice*** or method of dealing in a ***given industry or field.*** This can be introduced to clarify an otherwise ambiguous term.

Example: *S*, a wholesaler of widgets, signs a contract with *B*, a retailer of widgets, for a "gross" of widgets. *B* sends 144 widgets. *S* refuses delivery,

stating that "gross" in the widget industry means 100 units, not 144. Even if the writing is a complete integration, *S* will be permitted to show that under a widget-industry trade usage, "gross" means 100 units.

(3) Existence of a condition and/or formation defect. Parol evidence can be introduced as proof of a ***condition*** not included in the writing, as well as proof that the contract ***never legally came into existence.***

Example of condition: Painter signs a contract in which she agrees to paint Dave's portrait. Painter finishes the work, and demands payment. Dave asserts that he and Painter orally agreed that Dave would not have to pay for the painting unless Dave's wife liked it (which she doesn't). Even if the contract is an integration (final expression of parties' intent), Dave will be permitted to show that the parties agreed to the wife's-satisfaction condition.

Example of non-formation of contract: X and Y enter into a written contract whereby X agrees to build a brick fireplace for Y, and Y agrees to pay the sum of $1,000 to X's daughter on her birthday, February 12. Before signing the writing, X and Y orally agree that Y will make a reasonable effort to obtain a loan to pay for the work, but that if she is unsuccessful by January 1, the agreement will be canceled. Y is unable to obtain the loan by January 1 and calls off the deal. Y may introduce the evidence of the prior oral agreement, because it was a condition precedent to the formation of the contract.

☛ **Two types of integration:** Where a writing (or group of writings) represents only the entire ***written*** contract of the parties, but not their ***complete*** agreement, it is merely a ***"partial integration,"*** and evidence of ***consistent*** verbal understandings is ordinarily admissible (though evidence of inconsistent ones is not). But if the agreement does represent the complete agreement (***"total integration"***), it can't even be ***supplemented*** by evidence of prior agreements.

☞ The more ***informal*** and ***shorter*** the writing is, the ***more likely*** it is to be found to be ***merely a partial integration*** (which can therefore be supplemented by proof of consistent additional terms).

Example: If the agreement is in the form of a one- or two-sentence letter, its brevity will usually indicate that it wasn't intended to be a total integration.

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Interpretation and Construction in Contract Law

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When faced with questions of contract interpretation, courts commonly begin with the principle that "[t]he primary goal in interpreting contracts is to determine and enforce the parties' intent."[1] The maxim affirms that contractual obligations are chosen obligations. Parties acquire them by voluntarily entering into agreements whose terms they control. Contract interpretation therefore begins by seeking out the choices parties made. The maxim is of a piece with a picture of contract as a form of private legislation. Contract law gives parties the power to undertake new legal obligations when they wish. That power requires giving parties the obligations they intend. And the maxim serves to allocate responsibility. When a court enforces a contract, it is not imposing an obligation on a party, but merely giving effect to her own earlier choice. If a party is now unhappy with the contract terms, she has only her earlier self to blame.

But of course contractual obligations are not only a matter of party choice or intent. Sometimes when parties enter into the agreement, they do not have or do not express an intent one way or another on some issues—say whether the seller warrants the quality of the goods or the remedy for breach. Thus the importance of default rules in contract law, which determine parties' contractual obligation in the absence of evidence of their intent. Alternatively, the parties' expressions of their intent might be ambiguous. When this occurs, a court might apply a rule like *contra proferentem*, interpreting against the drafter, or the preference for

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[1] Old Kent Bank v. Sobczak, 243 Mich. App. 57, 63 (2000). A few other examples: "The fundamental, neutral precept of contract interpretation is that agreements are construed in accord with the parties' intent." Greenfield v. Philles Records, Inc., 98 N.Y.2d 562, 569 (2002). "Under statutory rules of contract interpretation, the mutual intention of the parties at the time the contract is formed governs interpretation." AIU Ins. Co. v. Superior Court, 51 Cal. 3d 807, 821 (1990) (*citing* Cal. Civ. Code § 1636). "The cardinal rule for interpretation of contracts is to ascertain the intention of the parties and to give effect to that intention, consistent with legal principles." Bob Pearsall Motors, Inc. v. Regal Chrysler-Plymouth, Inc., 521 S.W.2d 578, 580 (Tenn. 1975).

interpretations in the public interest, neither of which looks to party intent. There are also cases in which the parties' intent is clear, but a court will decline to give it legal effect. This is so when their agreement runs contrary to a mandatory rule, such as minimum wage or civil rights laws, the penalty rule, or the more general prohibition on enforcing agreements against public policy. Courts also often apply interpretive rules that predictably sometimes fail to capture what the parties actually intended. Plain meaning rules, for example, exclude context evidence that can be essential for understanding the parties' intent. Finally, "the parties' intent" is itself ambiguous. Does it refer to parties' intent with respect to their *legal* obligations? Or does it refer only to their intended *exchange*, from which those legal obligations flow?

In order to understand the relationship between parties' expressions of intent and their contractual obligations, one needs to distinguish two activities: interpretation and construction. Interpretation identifies the meaning of words or actions, construction their legal effect. Legal interpretation employs linguistic and other social abilities that originate outside the law. To live in a social world means to be constantly interpreting the words and actions of others. We interpret what people say, both expressly and by implication; the reasons for their actions; their beliefs and their intentions. Legal interpretation engages those interpretive skills, though it sometimes shackles them in one way or another. Rules of construction, in distinction, originate in the law. Rules of construction translate the output of interpretation into legal effects. Rules of construction therefore govern the relationship between the ordinary and the legal meanings of parties' words and actions, or between the parties' intent and their contractual obligations.

Although the distinction between interpretation and construction is easy to state in the abstract, a complete account of the two activities and the relationship between the two is no easy thing—even if one restricts the inquiry to interpretation and construction in contract law.[2] One reason is that contract interpretation takes several different forms. Depending on the details of the transaction and the legal question at issue, it might aim at the plain meaning of the parties' words, at those words' contextually determined use meaning, at subjective or at objective meaning, at an agreement's apparent purpose or purposes, or at what the parties believed or intended. Rules of contract construction also come in several varieties. They include the familiar categories of mandatory and default rules, as well

[2] The interpretation-construction distinction has recently received considerable attention from constitutional theorists, and especially originalist. *See, e.g.*, Lawrence B. Solum, *The Interpretation-Construction Distinction*, 27 Const. Comment. 95 (2010); Randy Barnett, *Interpretation and Construction*, 34 Harv. J.L. & Pub. Pol'y 65 (2011); Jack M. Balkin, *The New Originalism and the Uses of History*, 82 Fordham L. Rev. 641 (2013).

as the less familiar category of altering rules—rules that govern when parties words or actions suffice to contract out of a default legal state of affairs. And while some altering rules require interpretation of the parties' words and actions, others employ formalities that need no interpretation. Finally, the relationship between the activities of interpretation and construction is itself complex. In the order of application, interpretation comes first, construction second. One must often interpret the parties' words before one can determine their legal effect. But because legal interpretation is always in the service of construction, the correct approach to legal interpretation depends on the applicable rule of construction. And rules of construction sometimes affect the meaning of what parties say—both because acts of judicial construction can give words new conventional legal meanings and because parties often intend their words to have certain legal effects.

This Article provides a descriptive theory of interpretation and construction in the law of contracts and the interplay between the two activities.[3] Part One traces the history of the concepts in US law and legal theory, which provides the basis for a clearer understanding of each. The history focuses on three figures: Francis Lieber, Samuel Williston and Arthur Linton Corbin. Tracing the development of the concepts of interpretation and construction through these three authors suggests two different conceptions of them. In both Lieber and Williston, one finds a supplemental conception of interpretation and construction. For both, construction appears only when interpretation either runs out due to gaps or ambiguity or gaps or runs up against a higher-order rule. Corbin, in distinction, articulates a complementary conception of the two activities. According to Corbin, rules of construction apply throughout the process of contract exposition, operating also in the absence of gaps or ambiguities. Part One argues that the complementary conception provides the better theoretical account of the two distinct activities.

Part Two provides a systematic account of the rules of contract construction. Rules of construction include mandatory rules, default rules and altering rules. Over the past thirty years, contract theorists have had much to say about both mandatory and default rules. They have paid less systematic attention to altering rules, which govern what it takes to change

[3] Although Keith Rowley and Edwin Patterson each refer to the distinction between interpretation and construction in the title of an article, those works do not provide analyses of the distinction itself. *See* Keith A. Rowley, *Contract Construction and Interpretation: From the "Four Corners" to Parol Evidence (and Everything in Between)*, 69 Miss. L.J. 73 (1999); Edwin W. Patterson, *The Interpretation and Construction of Contracts*, 64 Colum. L. Rev. 833 (1964).

a default legal state of affairs.[4] Part Two describes the structure of contract altering rules and provides a typology of them. Altering rules determine among other things what types of meaning are legally salient, and thereby also how the parties' words and actions should be interpreted.

The description of altering rules provides the groundwork for Part Three's discussion of contract interpretation. The rules of contract construction call on several different types of meaning. These include plain meaning, use meaning, subjective meaning, objective meaning, purpose, and belief and intent. The correct approach to contract interpretation differs according to the facts of the case and the legal question at issue.

Part Four examines the interplay between interpretation and construction. Because legal actors often take account of the law when deciding what to say and do, interpreting their words and actions sometimes requires understanding the rules of construction they mean to satisfy or avoid. I term this the "pragmatic priority" of construction. Official acts of construction can also give words or entire clauses technical meanings, turning them into legal terms of art. This I call the "semantic priority" of construction. Consequently, whereas interpretation typically precedes construction in the order of exposition, there instances in which the interpreter must know the legal rule of construction in order identify the meaning of the parties' words or actions. The law of contract is designed to take advantage of this interplay.

Before proceeding further, a few words about method. This Article is about the structure and content of legal rules. My interest is therefore in the legally authorized activities of interpretation and construction. When I say that interpretation precedes construction in the process of exposition, I am saying something about the relevant legal rules. This is not to say that parties, judges or other legal actors always play by those rules. Legal actors, consciously or unconsciously, sometimes look to results before rules. And the rules themselves are loose enough to allow some play at the joints. Thus Corbin, ever the Legal Realist, observed:

> Just as construction must begin with interpretation, we shall find that our interpretation will vary with the construction that must follow. Finding that one interpretation of the words will be followed by the enforcement of certain legal effects, we may back hastily away from that interpretation and substitute another that will lead to a more desirable result.[5]

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[4] The first attempt at a systematic account of altering rules can be found in Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 Yale L.J. 2032 (2012).

[5] Arthur Linton Corbin, 3 Corbin on Contracts: A Comprehensive Treatise on the Rules of Contract Law § 534 at 11 (1951) (hereinafter "Corbin (1st ed.)"). Eyal Zamir makes a similar point in *The Inverted Hierarchy of*

This is an enormously important point, not in the least because the ability to substitute an interpretation that will lead to a more desirable result suggests that meaning is, to some degree and in some cases, indeterminate. The determinacy or indeterminacy of meaning has long been a topic of discussion and disagreement among legal theorists.[6] And the degree to which legal texts have stable, predictable and precise meanings is crucial to the justification and critical appraisal of rules of construction that take one or another form of meaning as their starting points.

That said, this Article is about the internal logic of legal rules that assume that words and other legally relevant acts often have sufficiently determinate meanings to bind future actors. From that point of view, outcome driven forms of interpretation are *ultra vires*. They do not belong to the internal logic of the law. This is not to say that they are not interesting or important. Only that they are not my topic here.

1 The Interpretation-Construction Distinction

Like all concepts, the ideas of interpretation and construction have a history. This Part traces the distinction from its origin in the work of Francis Lieber to the first edition of Samuel Williston's treatise, and then on to the first edition of Arthur Linton Corbin's treatise. That history shows a movement from a supplemental conception of interpretation and construction, according to which interpretation alone can answer some legal questions, to a conception of the two activities as complementary, according to which a rule of construction must always be applied to arrive at a legal result. I argue that the complementary conception of the distinction is the descriptively correct and more theoretically productive one.

1.1 Francis Lieber

The interpretation-construction distinction is commonly traced to Francis Lieber's 1839 book, *Legal and Political Hermeneutics, or Principles of Interpretation and Construction in Law and Politics*,[7] though Ralf Poscher

Contract Interpretation and Supplementation, 97 Colum. L. Rev. 1710 (1997).

[6] *See, e.g.*, Gary Peller, *The Metaphysics of American Law*, 73 Cal. L. Rev. 1151 (1985); Lawrence B. Solum, *On the Indeterminacy Crisis: Critiquing Critical Dogma*, 54 U. Chi. L. Rev. 462 (1987).

[7] Francis Lieber, Legal and Political Hermeneutics, or Principles of Interpretation and Construction in Law and Politics (enlarged ed. 1839/1970). The book is a reworking and expansion of two articles that appeared in *The American Jurist* in 1837 and 1838.

has suggested that Lieber's approach is rooted in Friedrich Schliermacher's earlier work on hermeneutics.[8]

Lieber understands successful communication to be the transmission of ideas from one person to another through the use of words or other signs. Interpretation is the activity of discovering those ideas. "Interpretation is the art of finding out the true sense of any form of words: that is, the sense which their author intended to convey, and of enabling others to derive from them the very same idea which the author intended to convey."[9] Lieber suggests that with respect to authoritative legal texts, successful interpretation suffices to identify the text's legal effect, which is the effect intended by the authority that authored or authorized that text. Although Lieber does not articulate a command theory of law, this account of interpretation is consistent with one.[10] The correct interpretation of a command identifies the intent of the authority who issued it—precisely how Lieber describes the correct interpretation of a legal text.

Lieber observes that sometimes interpretation alone is not enough to identify what the law is. In the course of *Legal and Political Hermeneutics*, he identifies several situations in which the "true significance," of a legal text might not fully determine what the associated law is: (1) when the text contains internal contradictions;[11] (2) "in cases which have not been foreseen by framers of those rules, by which we are nevertheless obliged, for some binding reason, faithfully to regulate, as well as we can, our

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[8] Ralf Poscher, *The Hermeneutical Character of Legal Construction*, *in* Law's Hermeneutics: Other Investigations 207, 207 (Simone Glanert and Fabien Girard eds., 2017).

[9] Lieber, *supra* note 7 at 23.

[10] *See* H.L.A. Hart, The Concept of Law 18-25 (2d ed. 1994); H.L.A. Hart, *Commands and Authoritative Legal Reasons*, *in* H.L.A. Hart, Essays on Bentham: Studies in Jurisprudence and Political Theory 243-268 (1982).

[11] Lieber, *supra* note 7 at 55-56. Today many theorists would also say that construction is necessary when a legal text is ambiguous. Lieber's intent-based understanding of meaning, however, leads him to conclude that a legal text cannot be ambiguous.

> No sentence, or form of words, can have more than one 'true sense,' and this only one we have to inquire for. . . . Every man or body of persons, making use of words, does so, in order to convey a certain meaning; and to find this precise meaning is the object of all interpretation. To have two meanings in view is equivalent to having no meaning—and amounts to absurdity. Even if a man use words, from kindness or malice, in such a way, that they may signify one or the other thing, according to the view of him to whom they are addressed, the utterer's meaning is not twofold; his meaning is simply not to express his opinion.

Id. at 86.

actions respecting the unforeseen case";[12] and (3) when the simple meaning of the text contravenes "more general and binding rules, [such as] constitutional, written and solemnly acknowledged rules, or moral ones, written in the heart of every man."[13] In each of these instances, interpretation alone cannot determine the legal outcome.

Lieber does not discuss contracts, but contract law includes rules that address each of the situations Lieber identifies. The Mirror Image Rule and section 2-207 of the Uniform Commercial Code (UCC), for example, each provides a rule to resolve potentially authoritative but conflicting contractual texts. Under the Mirror Image Rule, the terms in last document sent control (the "last shot rule").[14] Under section 2-207, conflicting terms drop out entirely and are replaced by Article Two's default terms.[15] In neither case does the rule turn on further interpretation of the meaning of the parties' words or intentions. Lieber's second category, "cases which have not been foreseen by the framers," describes both situations that trigger contractual defaults and the implied duty of good faith. Defaults apply when a contractual agreement is silent on a subject—when, in effect, the parties have not agreed on a relevant term.[16] The implied duty of good faith constrains a party's actions when a contractual agreement gives her discretion or does not fully specify her obligations, often due to unforeseen circumstances.[17] Finally, the doctrines of unconscionability and public policy both generate cases in which a text's legal effect is limited by "more general and binding rules."[18]

In each of these situations interpretation alone fails to specify the correct legal rule. We require supplemental rules or principles to determine the legal state of affairs. Lieber terms these rules of "construction."

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[12] *Id.* at 56.

[13] *Id.* at 166. Or again: "But it is not said that interpretation is all that shall guide us, and . . . there are considerations, which ought to induce us to abandon interpretation, or with other words to sacrifice the direct meaning of a text to considerations still weightier; especially not to slaughter justice, the sovereign object of laws, to the law itself, the means of obtaining it." *Id.* at 115.

[14] *See* E. Allan Farnsworth, Contracts § 3.21 (4th ed. 2004).

[15] The above statement of the section 2-207 rule for different terms oversimplifies, but is in the author's opinion the best reading of this poorly drafted statute. *See* 2 Anderson U.C.C. §§ 2-207:102 & 103 (3d. ed.). Other readings of section 2-207 provide alternative rules of construction for cases in which writings conflict.

[16] *See, e.g.* U.C.C. §§ 312, 314 & 315 (implied warranties of title, merchantability and fitness).

[17] *See* Daniel Markovits, *Good Faith as Contract Law's Core Value*, *in* Philosophical Foundations of Contract Law 272 (G. Klass, et al. eds., 2014).

[18] *See* Restatement (Second) of Contracts §§ 178-185, 208 (1981).

> In politics, construction signifies generally the supplying of supposed or real imperfections, or insufficiencies of a text, according to proper principles and rules. By insufficiency, we understand, both imperfect provision for the cases, which might or ought to have been provided for, and the inadequateness of the text for cases which human wisdom could not foresee.[19]

Construction is unavoidable because "[m]en who use words, even with the best intent and great care as well as skill, cannot foresee all possible complex cases, and if they could, they would be unable to provide for them, for each complex case would require its own provision and rule."[20]

Construction for Lieber therefore serves a gap-filling and equitable function. On Lieber's theory, "interpretation precedes construction" because construction steps in when interpretation runs out or runs up against a higher-order legal rule or principle.[21] For this reason, Lieber also sees a continuity of purpose between the two activities. "Construction is the drawing of conclusions respecting subjects, that lie beyond the direct expression of the text, from elements known from and given in the text—conclusions which are in the spirit though not within the letter of the text."[22] This supplemental conception suggests that, at least when extending a legal text to unforeseen cases, one should look for parallels covered cases. "Construction is the building up with given elements, not the forcing of extraneous matter into a text."[23] That said, Lieber recognizes that to arrive at the correct legal rule it is sometimes necessary to go beyond the "spirit" of the text. This is so when construction is required to cure some injustice in the law or conform it to a superior authority, as when a statute is construed to conform to constitutional requirements.[24]

The most interesting feature of Lieber's theory for the analysis that follows is this *supplemental conception* of interpretation and construction. Lieber describes construction as operating only in what Larry Solum calls the "construction zone": "the zone of underdeterminacy in which construction that goes beyond direct translation of semantic content into

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[19] *Id.* at 57.
[20] *Id.* at 121.
[21] "Since our object is to discover the sense of the words before us, we must endeavor to arrive at it as much as possible from the words themselves, and bring to our assistance extraneous principles, rules, or any other aid, in that measure and degree, only as the strictest interpretation becomes difficult or impossible, (interpretation precedes construction) otherwise interpretation is liable to become predestined." *Id.* at 113.
[22] *Id.* at 56.
[23] *Id.* at 124.
[24] *Id.* at 58-59.

legal content is required for application" of the rule.[25] According to Lieber's supplemental conception, construction steps in when interpretation fails to determine the text's legal effect.[26]

1.2 Samuel Williston

It would be interesting to trace the influence of Lieber's distinction between interpretation and construction throughout the next century of legal thought. Poscher suggests that it appears in somewhat different guise in Friedrich von Savigny's 1840 *System of Modern Law*.[27] William Story employs the categories in his 1844 *A Treatise on the Law of Contracts Not under Seal*, as does Theophilus Parsons in his 1855 *Law of Contract*.[28] Lieber's distinction also appears in the 1868 first edition of Thomas Cooley's treatise on the US Constitution, the same year Lieber's concepts first appeared in John Bouvier's legal dictionary.[29] James Bradley Thayer, in his 1898 *Treatise on Evidence*, expressly declines to adopt the distinction, arguing that "neither common usage nor practical convenience in legal discussions support [it]," and the concepts do not appear in Wigmore's 1905 or 1923 discussions of interpretation.[30] For my purposes, things become interesting with the 1920 first edition of Samuel Williston's *The Law of Contracts*. In section 602, "Construction and interpretation," Williston makes what I view as two improvements on Lieber's theory.

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[25] Solum, *supra* note 2 at 108 (2010) (internal punctuation omitted).

[26] What I am calling the "supplemental conception" is akin to what Solum calls the "Alternative Methods Model." Lawrence B. Solum, *Originalism and Constitutional Construction*, 82 Fordham L. Rev. 453, 498-99 (2013).

[27] Poscher, *supra* note 8 at 207.

[28] William W. Story, A Treatise on the Law of Contracts Not under Seal, § 228, at 148 (1844); 2 Theophilus Parsons, The Law of Contracts 3 n. a (1855); 4 John Henry Wigmore, A Treatise on the System of Evidence in Trials at Common Law, §§ 2458-2478 (1905); 5 John Henry Wigmore, A Treatise on the Anglo-American Law of Evidence in Trials at Common Law, §§ 2458-2478 (2d ed. 1924).

[29] Thomas M. Cooley, Treatise on the Constitutional Limitations which Rest upon the Legislative Power of the States of the American Union 89 n. 1 (1868); John Bouvier, A Law Dictionary Adapted to the Constitution and Laws of the United States of America 337 (12th ed. 1868).

[30] James Bradley Thayer, A Preliminary Treatise on The Law of Evidence at the Common Law 411 n. 2 (1898).

John Austin indicates something like Lieber's distinction in his *Fragments*, where he distinguishes between "[c]onsequences expressed by parties, and consequences annexed by law in default of such expression." John Austin, *Fragments—On Contracts*, *in* Lectures on Jurisprudence, or The Philosophy of Positive Law 939 (Robert Campbell ed., 4th ed. 1879).

First, Williston suggests a narrower conception of construction. The drawing of "conclusions that are in the spirit, though not in the letter of the text," Williston argues, is not different in kind from interpretation and "seems of no legal consequence as far as the law of contracts is concerned."[31] For example, when a court reads a written agreement "as a whole to determine its purpose and intent,"[32] it is engaging in a form of interpretation, even when the result supplements or even supplants the literal words in the agreement.[33] One must interpret an agreement to determine its purpose and the parties' likely intent. Better then, Williston suggests, to limit "construction" to activities entirely distinct from interpretation. For example, "when it is said that contracts which affect the public are to be construed most favorably to the public interest, it is obvious that the court is no longer applying a standard of interpretation, that is it is not seeking the intention of the parties."[34] Similarly when a guarantee is interpreted in favor of the guarantor. Construction, for Williston, is the category of rules whose function is not to realize or extend the parties' intentions, but that serve some other principle or purpose.

Although he advocates a narrower conception of construction, Williston follows Lieber is in conceiving construction as supplemental to interpretation. "[A] rule of construction can come into play only when the primary standard of interpretation leaves the meaning of the contract ambiguous."[35] Construction again appears only when interpretation runs out.

Williston's second innovation is to suggest that neither interpretation nor construction suffices to determine the legal state of affairs. Each concerns itself "with the legal meaning of the contract, not with its legal effect after that meaning has been discovered."[36] The legal effect,

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[31] Samuel Williston, 2 The Law of Contracts § 602, 1160 (1920) (hereinafter "Williston (1st ed.)").
[32] W.W.W. Assocs., Inc. v. Giancontieri, 77 N.Y.2d 157, 162 (1990).
[33] *See, e.g.*, McCoy v. Fahrney, 55 N.E. 61, 63 (Ill. 1899) ("Particular expressions will not control where the whole tenor or purpose of the instrument forbids a literal interpretation of the specific words.").
[34] Williston (1st ed.) at 1161.

Interestingly, Williston suggests that *contra proferentem*—the rule that ambiguities are to be interpreted against the drafter—is a rule of interpretation, "since it should be anticipated that the person addressed will understand ambiguous language in the sense most favorable to himself, and that his reasonable understanding should furnish the standard" *Id*. I would say this is at best a majoritarian rule of construction, and better supported by considerations of fairness and incentives than by the logic of interpretation.
[35] *Id*.
[36] *Id*.

Williston suggests, is a function of "substantive law of contracts which comes into play after interpretation and construction have finished their work."[37] Williston served as the Reporter for the first Restatement of Contracts, and a similar claim appears again in the comments to section 226: "Interpretation is not a determination of the legal effect of language. When properly interpreted it may have no legal effect, as in the case of an agreement for a penalty; or may have a legal effect differing from that in terms agreed upon, as in the case of a common-law mortgage."[38]

Williston therefore distinguishes three activities: (1) interpretation, which aims to get at the author's intention; (2) a supplemental activity of construction, which applies purely non-interpretive principles and steps in when interpretation runs out, such as in cases of irresolvable vagueness or ambiguity; and (3) the substantive law of contract, which specifies legal effects based on the work of interpretation and construction.

1.3 Arthur Linton Corbin

Corbin's 1951 treatise on contract law marks an important step forward in understanding the activities of interpretation and construction. Corbin provides the first clear account of construction as *complementing*, rather than merely supplementing, interpretation. He describes interpretation and construction as interlocking activities, each of which is necessary to determine what the law is.

> By "interpretation of language" we determine what ideas that language induces in other persons. By "construction of the contract," as the term will be used here, we determine its legal operation—its effect upon the action of courts and administrative officials. If we make this distinction, then the construction of a contract starts with the interpretation of its language but does not end with it; while the process of interpretation stops wholly short of a determination of the legal relations of the parties.[39]

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[37] *Id.*

[38] Restatement of Contracts §§ 226 cmt. c (1932).

[39] Corbin (1st ed.) § 534 at 7. Those interested in the development of Corbin's thoughts on the interpretation-construction distinction should begin with a passage he added on the subject as editor the 1919 third American Edition of Anson's *Principles of the Law of Contracts*. William Reynell Anson, Principles of the Law of Contract: With a Chapter on the Law of Agency, 14th English ed., 3rd American ed. § 353, 405-06 (Arthur L. Corbin ed. 1919) (*reprinted in* Arthur L. Corbin, *Conditions in the Law of Contract*, 28 Yale L.J. 739, 740-41 (1919)).

Whereas Williston distinguished between, on the one hand, legal rules that resolve ambiguities or fill gaps and, on the other, rules that determine the legal effect of an unambiguous text or other speech act, Corbin recognizes that those two activities are not different in kind. Both determine the legal effect of what the parties said and did, including what they did not say or do. Both should therefore be classified as rules of construction.

This more expansive view of construction—the activity of determining the legal effect of a legal actor's words and actions—allows Corbin to view construction as complementing, rather than supplementing, interpretation.[40] Both Lieber and Williston conceived of construction as stepping in only when interpretation runs out. Corbin suggests that determining the parties' contractual obligation always requires a rule of construction.[41] "[T]he process of interpretation stops wholly sort of a determination of the legal relations of the parties," because interpretation tells us only what some persons said, meant or intended. We require a rule of construction, or what H.L.A. Hart called a "rule of change,"[42] to determine which sayings or meanings or intendings of what legal actors have what legal effects.

Suppose, for example, an unemancipated minor and an adult each signs an identical enforceable agreement, each clearly evincing her intention that it be binding. Under US law, only the adult thereby acquires a nonvoidable contractual obligation.[43] The agreements and signatures have the same meaning; but meaning alone does not determine legal effect. That requires a rule of construction. Here the relevant rule provides that the adult's signature results in a nonvoidable contractual obligation, whereas the same act done by a minor creates an obligation that the minor can later disclaim. Rules of construction determine not only unintended legal consequences, as Lieber and Williston maintain, but also intended ones.

This broader conception of construction casts new light on the maxim that the primary goal of contract interpretation is to ascertain the parties' intent.[44] Although often treated as a rule of interpretation, the rule is in fact one of construction. It says that when adjudicators are determining contracting parties' legal obligations, they should look first to evidence of the parties' shared intentions. Generally speaking and *ceteris paribus*, contract law enforces the agreement that the parties intended. Such a rule is a rule of construction.

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[40] What I am calling the "complementary conception" of interpretation and construction is similar to what Solum calls the "Two Moments Model." Solum, *Constitutional Construction*, *supra* note 26 at 498-99.

[41] Thus Corbin could expressly reject Lieber's account of interpretation and construction. Corbin (1st ed.) § 534, at 11, n.11.

[42] Hart, The Concept of Law, *supra* note 10 at 95-96.

[43] *See* Restatement (Second) of Contracts § 14 (1981).

[44] *See supra* note 1

But that is only generally speaking. When parties have memorialized their agreement in an integrated writing, for example, their contractual rights and obligations might turn on the writing's plain meaning, even if one or both parties had a different understanding of its content. And other rules of construction—the ones Lieber and Williston emphasize, and that Corbin also discusses—hew even less closely to the parties' expressed intent. Examples include generic rules of construction like *contra proferentem* and the rule favoring interpretations that accord with public policy. Also in this category are the many default rules that determine parties' legal obligations absent their contrary expression, as well as mandatory rules that parties cannot contract out of, such as the duty of good faith. The rules of contract construction also include rules that deny enforcement based on the substance of an agreement, such as the rules for illegal agreements or the unconscionability doctrine. These and other extra-interpretive rules of construction apply when the object of interpretation is ambiguous, contradictory or gappy, when the situation is one that we believe lawmakers did not foresee, or when the text's meaning or parties' intent contravenes a higher legal authority or principle.

The important point, however, is Corbin's recognition that a text's meaning never suffices to determine its legal effect. Even when the text appears to fully determine the legal rule, it does so only by virtue of a rule of construction. Construction does not supplement interpretation, but complements it.

1.4 Interpretation and Construction

Corbin's complementary conception of interpretation and construction can be restated as follows: interpretation identifies the meaning of some words or actions, construction their legal effect. Rules of interpretation are used to discern the meaning of what parties say and do; rules of construction determine the resulting legal state of affairs.

One might think of rules of interpretation and rules of construction as two types of functions. A rule of interpretation takes as its input some domain of interpretive evidence. That evidence necessarily includes the act or omission whose meaning is at issue, which I will call the "interpretive object," as well as the interpreter's background linguistic and practical knowledge. Depending on the rule being applied, the interpretive input in a contract case might also include dictionary definitions and rules of syntax, testimony or other evidence of local linguistic practices, what was said during negotiations, any course of performance under the agreement at issue, any prior similar transactions between the parties, testimony as to how participants in the transaction meant or understood the interpretive object, evidence of the parties' reasons or motives for entering into the exchange, and so forth. A rule of interpretation maps that input onto a meaning, which interpretation ascribes to the interpretive object.

The output of legal interpretation—the meaning ascribed to the interpretive object—serves as an input for construction. Construction might take other input as well. A rule of contract construction might, for example, condition legal effects not only on what the speaker says—the meaning of her words and actions—but also on who she is, on the form in which she expresses herself, or on her use of conventional words or acts. And as will be discussed below, sometimes rule of construction requires no interpretation, as when parties employ a formality. A rule of construction maps those inputs onto a legal state of affairs. That is, it identifies their legal effect.

I will use "exposition" to refer to the entire process of determining the legal effect of a person or persons' words or actions. Exposition commonly involves both interpretation and construction. In the process of exposition, interpretation comes first, construction second. The reason is not, as Lieber and Williston suggest, that construction steps in only when interpretation runs out. It is that one generally must decide what words or actions mean before one can know their legal effects. As Corbin says, "A 'meaning' must be given to the words before determining their legal operation."[45] Or as I have put the point, the output of legal interpretation serves as the input for construction. That said, later parts of this Article identify other senses in which construction is sometimes or always prior to interpretation.

Although the interpretation-construction distinction has been around for over a century and a half, it is often ignored. Many contract scholars use "interpretation" to refer to the activity of construction. Ian Ayres: "Algebraically, one could think of interpretation as a function, *f()*, that relates actions of contractual parties, *a*, and the surrounding circumstances or contexts, *c*, to particular legal effects, *e*."[46] Richard Posner: "Contract interpretation is the undertaking . . . to figure out what the terms of a contract are, or should be understood to be."[47] Alan Schwartz and Robert Scott: "[A] theory of interpretation . . . 'maps' from the semantic content of the parties' writing to the writing's legal implications."[48] Contrariwise, and especially among British jurists and scholars, it is not uncommon to use "construction" to refer to the search for objective meaning, which is a form of interpretation as I am using the term.[49]

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[45] Corbin (1st ed.) § 534, 8.

[46] Ayres, *supra* note 4 at 2046.

[47] Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 Tex. L. Rev. 1581, 1582 (2005)

[48] Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 Yale L.J. 541, 547 (2003).

[49] For example, in his treatise, *The Construction of Commercial Contracts*, J.W. Carter defines "construction" as "the process by which the intention of the parties to a contract is determined and given effect to," and argues that

These *façons de parler* are fine as far as they go. The technical definitions of "interpretation" and "construction" depart from those words' everyday meanings, and there is nothing wrong with using common words in accordance with common usage. But there is a difference between the activities of interpretation and construction. Corbin again: "there is no identity nor much similarity between the process of giving a meaning to words, and the determination by the court of their legal operation."[50] Attention to the difference, and to the different rules that govern each activity, is essential to a clear understanding of how law translates words and actions into legal effects. The advantage of adhering to the terms' technical meanings is that it forces one to keep in view the difference between the two activities, and to be clear about what one is talking about when.

2 Rules of Contract Construction

Having distinguished the activities of interpretation and construction, it is now possible to take a closer look at the rules that govern each. This Part provides an account of the rules of contract construction; Part Three discusses varieties of contract interpretation.

The rules of contract construction divide into three broad categories: mandatory rules, default rules and altering rules. A *mandatory rule* specifies a legal state of affairs that applies no matter what legal actors say and do. Thus when the Second Restatement observes that "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement," it states that the parties who have entered into a contract have a duty of good faith no matter what.[51] The duty cannot be disclaimed. Other examples include the minimum wage and civil rights laws, the penalty rule for liquidated damages, and the nonenforcement of contracts contrary to public policy. A *default rule* specifies the legal state of affairs absent evidence the right person's or persons' contrary intent. Familiar examples in contract law include the rule that an offer on which the offeree has not relied is revocable;[52] the implied

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"since even a decision on the linguistic meaning of words may determine the legal rights of the parties, there seems little point in seeking to distinguish between a process called 'interpretation' and one which is termed 'construction.'" J.W. Carter, The Construction of Commercial Contracts 4 & 6 (2013).

[50] 3 Corbin (1st ed.) § 534, 11.

[51] Restatement (Second) of Contracts § 205 (1981). This is not to say that the parties cannot alter the specific requirements of that obligation through their words and actions. The point is only that they cannot escape the duty altogether.

[52] *See* Restatement (Second) of Contracts § 42 cmt. a (1981).

warranty of merchantability that attaches to a merchant's sale of goods;[53] and most rules governing the calculation of damages for breach.[54] An *altering rule* specifies whose saying of what suffices to effect one or another change from the default legal state of affairs.[55] Thus a merchant selling goods can make her offer irrevocable for up to three months by expressing her intent to do so in a signed writing;[56] a seller can disclaim the implied warranty of merchantability by using words like "as is" or "with all faults";[57] and parties can generally agree to liquidate or limit damages for breach by expressing their shared intent to do so.[58]

This Part focuses on default and altering rules, which together translate parties' words and actions into contractual obligations.

2.1 Default Rules

Contract scholars often speak of default rules as "rules of interpretation," and commonly use terms like "default interpretations" or "interpretive defaults."[59] One reason for this way of speaking is inattention to the interpretation-construction distinction. The inattention is fine so long as everyone is clear that "interpretation" is being used to include construction. If one attends to the difference between the two activities, it is clear that default rules are rules of construction. A default rule determines the *legal* state of affairs absent the parties' expression to the contrary. As Corbin observes, "[w]hen a court is filling gaps in the terms of an agreement, with respect to matters that the parties did not have in contemplation and as to which they had no intention to be expressed, the judicial process . . . . may be called 'construction'; it should not be called 'interpretation.'"[60]

Another reason why contract scholars might associate defaults with rules of interpretation is that defaults rules are often designed to get at what

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[53] U.C.C. § 2-314(1).
[54] *See* Restatement (Second) of Contracts §§ 346-52 (1981).
[55] I take this term from Ian Ayres's important work, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 Yale L.J. 2032 (2012). *See also* Brett McDonnell, *Sticky Defaults and Altering Rules in Corporate Law*, 60 SMU L. Rev. 383 (2007). In earlier work, I have analyzed altering rules under the heading of "opt-out" rules. Gregory Klass, *Intent to Contract*, 95 Va. L. Rev. 1437 (2009).
[56] U.C.C. § 2-205.
[57] U.C.C. § 2-316(3)(a).
[58] Restatement (Second) of Contracts § 356 (1981).
[59] A search of Westlaw's JLR database finds 85 articles using "default interpretation," 88 using "interpretive default," and 52 using "default rule of interpretation." Search run on January 2, 2018.
[60] 3 Corbin (1st ed.) § 534 at 9.

parties probably intended, or would have intended had they thought about the matter, and these can look like interpretive questions. Thus Richard Posner writes: "Gap filling and disambiguation are both . . . 'interpretive' in the sense that they are efforts to determine how the parties would have resolved the issue that has arisen had they foreseen it when they negotiated their contract."[61]

I do not want to claim a monopoly on the word "interpretation." But neither setting a majoritarian default nor seeking what particular parties would have agreed to requires interpretation in the sense in which this Article uses the term. Predicting parties' probable preferences or intentions is not the same as interpreting what individual parties said or did in a particular transaction.[62] Moreover, not all default rules are or should be majoritarian ones or correspond to what the parties would have agreed to.[63] Lawmakers might set the default to accord with public policy or other social interests as a way to guide parties to socially desirable outcomes. Or they might adopt a penalty default that is designed not to get at the terms most parties want or would have chosen, but to give one or both parties a new reason to share information by opting out of the default.

The above paragraphs barely scratch the surface of the extensive literature on default rules in contract law. This Article's primary contribution to that literature is simply to clarify how one should understand of default rules. Default rules are not rules of interpretation, but rules of construction. Once one recognizes this fact, it is not surprising that they might be designed with a view to factors other than parties' probable intentions or hypothetical agreement. The social interests in the enforcement contractual agreements extend beyond party choice.

2.2 Altering Rules

Every default comes with an altering rule. To describe a legal state of affairs as a default is to say that some person or persons might change it by saying the right thing in the right way. Who must say what how is determined by an altering rule. As Ian Ayres writes, "[a]n altering rule in essence says that if contractors say or do this, they will achieve a particular

[61] Posner, *supra* note 47 at 1586.

[62] For a variation on this point, see Seana Valentine Shiffrin, *Must I Mean What You Think I Should Have Said?*, 98 Va. L. Rev. 159, 163 (2012); Gregory Klass, *To Perform or Pay Damages*, 98 Va. L. Rev. 143, 145-47 (2012).

[63] Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87 (1989).

contractual result."[64] Because altering rules describe the *legal* effects of what parties say and do, they too are rules of construction.

All altering rules share a tripartite structure specifying actor, act and effect. An altering rule provides that if (1) the right actor or actors (2) performs a specified act, then (3) a certain nondefault legal state of affairs will pertain. Article Two's rule for firm offers not supported by consideration provides a useful example. The default rule for offers is that they are revocable. Section 2-205 provides an associated altering rule:

> An offer by a merchant to buy or sell goods in a signed writing which by its terms gives assurance that it will be held open is not revocable, for lack of consideration, during the time stated or if no time is stated for a reasonable time, but in no event may such period of irrevocability exceed three months.

The rule establishes (1) whose acts are relevant: those of a merchant buyer or seller of goods; (2) what acts are sufficient to displace the default: a signed written assurance that the offer will be held open; and (3) the term that substitutes for the default: irrevocability for the time stated or, if no time is stated, for a reasonable time, but in no case for more than three months. This Article focuses on the second element of altering rules: the identification of acts that suffice to displace the default. I call these "altering acts."

Altering acts can have multiple salient features. Consider again the section 2-205 rule for firm offers. In order to be irrevocable under the rule, a merchant's offer must satisfy three requirements. It must (a) "by its terms give[] assurance that it will be held open," (b) be in writing, and (c) be signed. Determining whether the first requirement is met—whether the right sort of assurance was given—requires interpretation, even if only to ascertain the literal meaning of the merchant's words. Determining whether the second and third requirements are satisfied—whether the assurance was in writing and whether it was signed—does not require interpretation. The first requirement is that the offer perform an act with the right meaning, the second and third that the act be of the right form.

I will call rules that condition legal outcomes on the meaning of what the parties say and do "interpretive components" of altering rules, and rules that condition legal outcomes on facts that can be ascertained without

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[64] Ayres, *supra* note 4 at 2036. I do not think that Ayres gets things quite right when he writes that altering rules are "*the necessary and sufficient conditions for displacing a default legal treatment with some particular other legal treatment*." *Id.* at 2036. It is more helpful to think of altering rules as specifying acts sufficient to displace a default, but not necessary to do so. Contract law often provides several separate paths to effecting a legal change.

interpretation "formal components." An interpretive component requires interpretation of the parties' words and actions to determine whether they have effected a legal change. A formal component requires examination of formal qualities of the parties' words and actions.

Any given altering rule might have only interpretive components, only formal components, or a mix of the two. I will say that an altering rule that includes only formal components is "formalistic," and the altering acts such a rule specifies "formalities." Consider section 2-319 of the Code, which provides that, "when the term is F.O.B. the place of shipment, the seller must at that place ship the goods in the manner provided in this Article . . . and bear the expense and risk of putting them into the possession of the carrier." According to this rule, the letters "F.O.B." plus the name of a place suffice to effect the legal change. No further inquiry into what the parties or their words meant is required. The rule is a formalistic one, establishing "F.O.B." as a legal formality. The section 2-316 rule for "as is" and "with all faults" is similarly formalistic. It provides that, *ceteris paribus*, the mere use of those words is enough to exclude all implied warranties. So too, famously, the common law and statutory rules governing the legal effect of the seal.[65]

I will say that altering rules that are not formalistic are "interpretive." Interpretive altering rules always contain an interpretive component. The application of an interpretive altering rule requires interpretation of the parties' words and actions. Interpretation enters the process of legal exposition by way of interpretive altering rules.

An interpretive altering rule might or might not include formal components. I will call altering rules that do not include formal components "pure interpretive altering rules." The Second Restatement defines an offer, for example, as any "manifestation of willingness to enter into a bargain."[66] The rule requires interpretation of a party's words and actions to determine whether there has been an offer. But it does not condition the legal effect of those words or actions on their formal qualities, such appearing in a writing or with a signature. Similarly, UCC section

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[65] Altering rules can specify legal effects that are either defeasible or non-defeasible, depending on whether the resultant legal state of affairs is default or mandatory. Most modern formalistic altering rules establish defeasible effects. The Second Restatement, for example, provides that "[t]he adoption of a seal may be shown or negated by any relevant evidence as to the intention manifested by the promisor." Restatement (Second) Contracts § 98 cmt. a (1981). *See also* 1 Williston on Contracts § 2:2 n.11 (4th ed. 2016) (citing cases); Eric Mills Holmes, *Stature & Status of a Promise Under Seal as a Legal Formality*, 29 Willamette L. Rev. 617, 636-37 (1993) (discussing the modern requirement of a party's intent to deliver the sealed instrument).

[66] Restatement (Second) of Contracts § 24 (1981).

2-204's formation rule: "A contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract."[67] Determining whether the parties have agreed to a sale of goods requires interpreting their words and conduct. The rule is an interpretive one. Because section 2-204 does not impose any formal requirements, it too is a pure interpretive altering rule.[68]

I will call interpretive altering rules that that have one or more formal components "mixed interpretive rules." The section 2-205 rule for firm offers is a mixed interpretive rule. It requires both that a merchant seller say words with the right meaning—that the offer "by its terms gives assurances that it will be held open"—and that those words be in the right form—"in a signed writing." A merchant's offer must satisfy both the interpretive and the formal components to be a firm offer pursuant to the rule.

The distinction between formal and informal components therefore produces a typology of altering rules that can be represented in a two-by-two table.

Types of altering rules

Formal Component	Interpretive Component: Yes	Interpretive Component: No
Yes	mixed interpretive rules (UCC rule for firm offers)	formalistic rules ("as is," "F.O.B.")
No	pure interpretive rules (generic rules for agreement)	

Part Three discusses interpretive altering rules. Formalistic altering rules figure into the discussion of Part Four.

Lastly, it is worth nothing that altering rules themselves can be mandatory or default rules. Contract law grants parties broad powers not only over their first-order legal obligations to one another—roughly, the

[67] U.C.C. § 2-204.

[68] Other sections of the code add formal requirements for some contract types, most obviously the Code's Statute of Frauds. U.C.C. § 2-201.

obligations whose nonperformance constitutes a breach[69]—but sometimes also over the framework rules that determine when those obligations come into existence and what their content is.

The mailbox rule provides a simple example. The rule establishes precisely when an acceptance effects a legal change, and is therefore a component of the effects-prong of formation altering rules. A mailed acceptance is effective "as soon as it is put out of the offeree's possession, without regard to whether it ever reaches the offeror."[70] That rule, however, does not apply if "the offer provides otherwise."[71] The mailbox rule itself is a default rule. An offeror has the power to stipulate, for example, that an acceptance shall be effective only upon receipt.

The parol evidence rule provides another, somewhat more complex, example. The contemporary default rule is that writings are given no special weight in determining parties' contractual obligations.[72] If, however, parties agree that a writing shall serve as a final expression of some or all of the contract between them—that the writing shall be "integrated"—parol evidence of contrary or additional terms is generally excluded.[73] Integration alters the default legal effects of the writing and of extrinsic evidence. U.S. courts generally recognize two ways parties can effectively express or evince their shared intent that a writing be integrated. They can include in the writing an integration clause, which expressly states that it is the final statement of some or all terms. Or, absent an integration clause, a writing will be judged integrated if "in view of its completeness and specificity reasonably appears to be a complete agreement, it is taken to be an integrated agreement."[74] These are altering rules. Each specifies how parties can effectively express their intent that the writing serve as a final statement of terms.

Although many rules of construction are defaults, there are also mandatory limits on the parties' ability pick and choose those rules. A clause that requires modifications to be in writing might be ineffective

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[69] In addition to first-order duties, a contract might provide for first-order permissions, powers and other legal relations. Here and in much of the rest of this essay, for the sake of simplicity I ignore these other types of contract terms.

[70] Restatement (Second) Contracts § 63 (1981).

[71] *Id.*

[72] This was not always the case. Under the old best evidence rule, a writing automatically excluded all oral evidence of contrary terms. The best evidence rule established an evidentiary hierarchy: written evidence, which was commonly under seal, could not be contradicted by oral evidence. *See, e.g.*, Salmond, *The Superiority of Written Evidence*, 6 L. Q. Rev. 75 (1890).

[73] Restatement (Second) of Contracts § 213 (1981).

[74] Restatement (Second) of Contracts § 209(3) (1981).

under common law, though effective under the Uniform Commercial Code.[75] Courts do not enforce provisions that purport to alter the rules governing waivers.[76] And integration will not prevent a party from later introducing parol evidence of "illegality, fraud, duress, mistake, lack of consideration, or other invalidating cause."[77]

* * *

The analysis so far can be summarized as follows. Legal exposition involves two separate activities: interpretation, which identifies the meaning of the parties' words and actions, and construction, which identifies their legal effect. Rules of construction include mandatory, default and altering rules. A mandatory rule says what the legal state of affairs is no matter what the parties say or do. A default rule says what the legal state of affairs is absent the parties' contrary expression. An altering rule identifies contrary expressions sufficient to effect a change from the default. Altering rules can have interpretive and formal components. Interpretive components condition legal change on the performance of acts with the right meaning. Formal components condition legal change on the performance of acts of the right form. Formalistic altering rules have only formal components. Pure interpretive rules have only interpretive components. Mixed interpretive rules have both formal and interpretive components.

Conceptual distinctions and taxonomies are of value when they shed new light on old questions. The argument for the above categories can therefore be found in the remainder of this Article. That said, it is already possible to identify an example of their utility. Eric Posner has suggested that "[a]n interesting aspect of the Statute of Frauds and other contract formalities is that they do not fit easily into the default-immutable rule dichotomy frequently used by contract theorists."[78] The reason is that the default-immutable rule, or default-mandatory rule, dichotomy is incomplete. Statutes of Frauds and other formal requirements belong to a third category: altering rules. A writing requirement like a Statute of Frauds is not itself an altering rule, but is sometimes a component of other altering

[75] *See* Samuel Williston, 29 Williston on Contracts § 73:22 (4th ed.) (no-oral-modification clauses ineffective); U.C.C. 2-209(2) (no-oral-modification clauses effective).

[76] *See* 13 Williston on Contracts § 39:36 (4th ed.) ("[A] provision that a term or condition of any sort cannot be eliminated by a waiver, or by an estoppel, is ineffective, and a party has the same power to waive the condition, or to be estopped from asserting it, as though the provision did not exist.").

[77] Restatement (Second) Contracts § 214(d) (1981).

[78] Eric A. Posner, *Norms, Formalities, and the Statute of Frauds: A Comment*, 144 U. Pa. L. Rev. 1971, 1981 (1996).

rules. In the transactions to which it applies, a Statute of Frauds adds a formal component: the parties' agreement must be evidenced by a signed writing.[79] Altering rules and their components, like any other framework contract rules, can themselves be mandatory or default. As it happens, Statutes of Frauds are mandatory components of the altering rules into which they figure. Parties cannot contract out of their writing requirements. Although a complete understanding of such formal requirements demands a richer conceptual toolkit, a Statute of Frauds therefore also fits "into the default-immutable rule dichotomy."

3 The Varieties of Contract Interpretation

Part One emphasized differences among how Lieber, Williston and Corbin conceive interpretation and construction and the relationship between the two activities. But there is a similarity among their understandings of interpretation. Each has a relatively narrow conception of meaning. For Lieber, "[t]rue sense is . . . the meaning which the person or persons, who made use of the words, intended to convey to others, whether he used them correctly, skillfully, logically or not."[80] Williston follows Lieber's intentionalist account: "Interpretation is the art of finding out the true sense of any form of words: that is, the sense which their author intended to convey, and of enabling others to derive from them the very same idea which the author intended to convey."[81] Corbin adopts a listener-centered account of meaning, but one that is similarly one-dimensional. "By 'interpretation of language' we determine what ideas that language induces in other persons."[82]

These simple accounts of meaning, and by extension interpretation, oversimplify. This Part argues that contract law's interpretive altering rules recognize and give legal effect to several different types of meaning.[83] These

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[79] This is roughly the basic requirement of Article Two's writing requirement. U.C.C. § 2-201(1). The rule in section 2-201 of the Code contains exceptions and qualifications that are not captured in the above. And other Statutes of Frauds require additional things of the writing. The Second Restatement, for example, suggests that the contents of the writing must (1) reasonably identify the subject matter of the contract; (2) indicate that a contract has been made; and (3) state the essential terms of the unperformed promise. Restatement (Second) Contracts § 131 (1981).

[80] Lieber, *supra* note 7 at 23. *See also id.* at 19 ("[I]t is necessary for him, for whose benefit [a sign] is intended, to find out, what those persons who use the sign, intend to convey to the mind of the beholder or hearer.").

[81] Williston (1st ed.) § 602, at 1159-60 (quoting Lieber, *supra* note 7 at 23).

[82] Corbin (1st ed.) § 534, at 7.

[83] Lieber expressly rejects the idea that there are multiple types of meaning relevant to the law, contrasting legal to Biblical interpretation.

include plain meaning, context dependent use meaning, subjective and objective meaning, an agreement's or term's purpose, and the parties' intentions and beliefs. Each can, under the right circumstances, figure into determining the existence or content of a contract. Each is identified by interpretation of the parties' words and actions. And the legal relevance of each is determined by a rule of construction.

Two scholars have recently suggested that public laws too have multiple meanings. Cass Sunstein argues that "there is nothing that interpretation 'just is,'" and that "no approach to constitutional interpretation is mandatory."[84] And Richard Fallon identifies a "diversity of senses of meaning that constitute . . . potential 'referents' for claims of legal meaning."[85] Sunstein suggests an outcome-based approach the choice among interpretive methods in constitutional law. "Among the reasonable alternatives, any particular approach to the Constitution must be defended on the ground that it makes the relevant constitutional order better rather than worse."[86] To date Sunstein he has not made an outcome-based case for one or another form of constitutional interpretation. Fallon argues that it is a mistake to equate statutory or constitutional meaning with any one type of meaning. Rather than selecting a single mode of interpretation on the basis of overall outcomes, Fallon recommends "a relatively case-by-case approach to selecting" the appropriate sort of meaning.[87]

Neither Sunstein's nor Fallon's theory describes the choice of meaning in the law of contracts. In contract exposition, different types of meaning are relevant in different circumstance and to different legal questions. And generally accepted rules of construction govern which type of meaning is legally relevant when. Contract law thereby illustrates how legal exposition can incorporate multiple types of meaning in a rule-

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> Owing to the peculiar character which the Bible possesses, as a book of history and revelation, and the relation between the old and new testaments, we find that some divines ascribe various meanings to the same passages or rites, and that different theologians take the same passage in senses of an essentially different character. We hear thus of typical, allegorical, parabolical, anagogical, moral and accommodatory senses, and of corresponding modes of interpretation. . . . In politics and law we have to deal with plain words and human use of them only.

Lieber, *supra* note 7 at 75-76.

[84] Cass Sunstein, *There Is Nothing that Interpretation Just Is*, 30 Const. Comment. 193, 193 (2015).

[85] Richard H. Fallon, Jr., *The Meaning of Legal "Meaning" and Its Implications for Theories of Legal Interpretation*, 82 U. Chi. L. Rev. 1235, 1239 (2015).

[86] Sunstein, *supra* note 84 at 212.

[87] Fallon, *surpra* note 85 at 1303.

governed way. And it exemplifies how what counts as the right approach to legal interpretation depends on the relevant rule of construction, as the complementary conception suggests it must.

This Part focuses on the interpretation of contractual agreements. But it is worth remembering that agreements are not the only types of altering acts that contract law recognizes. Offers, rejections, counter offers, retractions, preliminary agreements, modifications, waivers, repudiations, demands for adequate assurance, cancellations, elections of remedies and other meaningful acts before and after formation can alter the parties' contractual rights, obligations, powers, privileges and so forth. All of commonly require interpretation to determine their legal effect. This Part makes only a start at describing the varieties of interpretation in contract law.

3.1 Plain Meaning and Use Meaning

Perhaps the most contested question about contract interpretation concerns the choice between plain meaning and use meaning. In contract law, "plain meaning" generally refers to the meaning an experienced interpreter can glean from a writing using nothing but a dictionary, her knowledge of the English language, and her generic understanding of the social world. Because plain meaning interpretation uses so few inputs, a writing's plain meaning often is its literal meaning. But not always. A written agreement read as a whole, for example, might evince a general purpose which suggests that a provision in it should not be read literally. As Williston explained in the first edition of his treatise:

> in giving effect to the general meaning of a writing particular words are sometimes wholly disregarded, or supplied. Thus "or" may be given the meaning of "and," or vice versa, if the remainder of the agreement shows that a reasonable person in the position of the parties would so understand it.[88]

The plain meaning of words is their meaning stripped of context, but not entirely of apparent intention.[89]

I will use "use meaning" to refer to how a reasonable person would understand the parties' words or actions in light of the relevant circumstances of their use. An agreement's plain and use meanings sometimes diverge. Parties sometimes objectively use and understand words to mean something other than their plain meanings. To take a

[88] 2 Williston (1st ed.) § 619, 1199.

[89] In other words, plain meaning is not necessarily semantic meaning. I discuss the distinction between semantic and pragmatic meaning in Part Four.

famous example, consider a clause in a contract for the repair of a steam turbine that indemnifies the owner "against all loss, damage, expense and liability resulting from . . . injury to property." Read literally and without context, the clause covers all losses, including those of the owner. But it is easy to imagine that the parties' reasons for adding the clause, their past dealings, or a course of performance could cause them to reasonably understand the clause to cover only third-party losses. In such a case, the words' plain meaning would diverge from their use meaning.

Contract law recognizes that even in an integrated writing—one that the parties intend to be a final statement of some or all terms of their agreement—plain meaning can diverge from use meaning. As just about every first-year US law student learns, US jurisdictions take different approaches to the possibility of such divergences. In *Pacific Gas & Electric v. G.W. Thomas Drayage & Rigging*, the California Supreme Court held,

> The test of admissibility of extrinsic evidence to explain the meaning of a written instrument is not whether it appears to the court to be plain and unambiguous on its face, but whether the offered evidence is relevant to prove a meaning to which the language of the instrument is reasonably susceptible.[90]

This California rule eschews exclusive reliance on plain meaning and instructs courts to look in the first instance to an integrated writing's use meaning—to how the parties reasonably understood the words in the circumstances of the writing's production. At issue in *Pacific Gas* was the legal effect of the above indemnification clause. The court concluded that the defendant should have been allowed to introduce extrinsic evidence that the parties understood the clause to cover only third-party losses.

New York courts apply a very different rule. In *W.W.W. Assoc. v Giancontieri*, for example, the New York Court of Appeals held that "when parties set down their agreement in a clear, complete document, . . . [e]vidence outside the four corners of the document as to what was really intended but unstated or misstated is generally inadmissible to add to or vary the writing."[91] Under *Giancontieri*, when the plain meaning of an integrated writing is unambiguous, that meaning governs. In New York, the *Pacific Gas* indemnification clause would cover both third-party and owner losses.

There is a lively debate among contracts scholars as to which rule is better. Interesting though the question is, I am not going to weigh in on it here. Instead, I want to make four points about the choice between plain and use meaning.

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[90] Pac. Gas & Elec. Co. v. G. W. Thomas Drayage & Rigging Co., 442 P.2d 641, 644 (Cal. 1968).

[91] W.W.W. Associates, Inc. v. Giancontieri, 77 N.Y.2d 157, 162 (1990).

First, both the *Pacific Gas* and the *Giancontieri* rules are rules of construction. More specifically, they are interpretive altering rules. *Pacific Gas* holds that the parties' legal obligations depend on the contextually determined use meaning of their words, even when the parties have reduced their agreement to an integrated writing that appears unambiguous on its face. The holding in *Giancontieri* is that when an integrated writing is on its face unambiguous, the parties' legal obligations depend on the writing's plain meaning only. Each rule establishes which type of meaning is legally salient.

Second, by determining which sort of meaning is legally salient, these rules thereby determine what sort of interpretation legal decision makers should engage in. In New York, a court should first aim to interpret an integrated agreement's plain meaning; in California it should begin with the writing's use meaning. I have observed that in the order of application, interpretation comes first, construction second. But because legal interpretation serves construction, the correct approach to legal interpretation depends on the applicable rule of construction. Rules of construction are conceptually prior to legal interpretation.

Third, the design choice is not simply between plain meaning and use meaning, but is about which type of meaning is relevant when. This is most obvious under the New York rule. *Giancontieri* states that if the plain meaning of an integrated writing is unambiguous, that meaning controls. When the writing's plain meaning is ambiguous, however, parties are free to introduce extrinsic evidence to show which meaning they intended and the reasonable understanding of the words in the context in which they were produced.[92] In other words, when plain meaning runs out, legal interpreters should turn to use meaning. Nor is it obvious that New York courts would apply to the plain meaning rule to informal, non-integrated writings or to oral agreements. New York's plain meaning rule does not eschew use meaning altogether, but identifies a narrower band of cases in which use meaning is legally relevant than does the California rule.

Finally, both the California and the New York rules are probably default rules. Alan Schwartz and Robert Scott discuss examples of contract clauses that expressly instruct courts to construe the agreement according to its plain meaning.[93] Alternatively, parties might include a clause instructing

[92] *See, e.g.*, Pouch Terminal, Inc. v. Hapag-Lloyd (Am.) Inc., 569 N.Y.S.2d 122, 123 (2d Dep't 1991) ("Where . . . the language of a contract is susceptible of varying but reasonable interpretations, the parties may submit extrinsic evidence as an aid in construction, and the resolution of the ambiguity is for the trier of fact").

[93] Alan Schwartz & Robert E. Scott, *Contract Interpretation Redux*, 119 Yale L.J. 926, 955 (2010).

courts to construe their agreement according to its use meaning.[94] Although there is not much case law on the effectiveness of such contractual provisions, a court would be hard pressed to altogether ignore such instructions from sophisticated parties. And though the Second Restatement casts some doubt on the rule, integration can also make a difference to the choice between plain and use meaning.[95]

3.2 Subjective and Objective Meaning

The distinction between plain and use meaning is not the only divide among legally relevant meanings in contract cases. Rules of construction also govern the choice between subjective and objective meaning.

In contract law, "subjective meaning" refers to what a speaker actually intended her words and actions to communicate or to what a hearer actually understood them to mean, "objective meaning" to what a reasonable person would understand those words and actions to mean. Subjective meaning can be private; objective meaning is always public. In the casebook staple *Embry v. Hargadine, McKittrick Dry Goods Co.*, for example, a Missouri appellate court considered the correct interpretation of the words "Go ahead, you're all right; get your men out and don't let that worry you," spoken by the company's president, McKittrick, to an employee, Embry, who was threatening to quit unless given a new contract.[96] At trial the jury was instructed to find that there was a contract only "if you (the jury) find both parties thereby intended and did contract with each other for plaintiff's employment."[97] The appellate court held this was an error. "[T]hough McKittrick may not have intended to employ Embry by what transpired between them . . ., yet if what McKittrick said would have been taken by a reasonable man to be an employment, and Embry so understood it, it constituted a valid contract of employment."[98] In

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[94] *See, e.g.*, Corthell v. Summit Thread Co., 167 A. 79, 80 (Me. 1933) (written agreement specifying that it "is to be interpreted in good faith on the basis of what is reasonable and intended and not technically").

[95] This was Williston's view. *See* 2 Williston (1st ed.) § 606, 1165. The Second Restatement is more equivocal on the point. Section 212(1) provides that "The interpretation of an integrated agreement is directed to the meaning of the terms of the writing or writings in the light of the circumstances." Yet section 212(2) suggests that when the plain meaning of a writing is unambiguous, that meaning is to be determined by the court rather than the finder of fact.

[96] 105 S.W. 777, 777 (Mo. Ct. App. 1907).

[97] *Id.* at 778.

[98] *Id.* at 779.

short, the existence of a contract depended on the objective meaning of the company president's statement, not on his subjective understanding of it.

Plain meaning is always objective, as the inputs of plain meaning interpretation do not include evidence of privately held understandings. Use meaning can be understood subjectively or objectively. Objective use meaning is the meaning a reasonable observer would attribute to the words or actions in the context of their use. Thus the court in *Embry* interpreted the objective use meaning of McKittrick's statement to be an agreement to renew the employment contract.

> [W]hen [Embry] was complaining of the worry and mental distress he was under because of his uncertainty about the future, and his urgent need, either of an immediate contract with respondent, or a refusal by it to make one, leaving him free to seek employment elsewhere, McKittrick must have answered as he did for the purpose of assuring appellant that any apprehension was needless, as appellant's services would be retained by the respondent. The answer was unambiguous.[99]

An utterance's or writing's subjective use meaning is a party's actual understanding of it, which might or might not be how a reasonable observer would understand it in the circumstances of its production. If, as the jury might have found, McKittrick believed he was not agreeing to renew Embry's contract, McKittrick's subjective understanding of his words departed from their objective meaning in the circumstances of their utterance.

In the early twentieth century, scholars and jurists devoted considerable attention to the choice between subjective and objective forms of interpretation.[100] With respect to the interpretation of contractual agreements, most courts today follow section 201 of the Second Restatement, which looks to a mix of subjective and objective meaning. Oversimplifying a bit, when the parties' subjective meanings converge, those subjective meanings govern; when the parties attach different subjective meanings to their words and actions, objective meaning governs.[101]

Section 201 is another interpretive altering rule. Like the rules in *Pacific Gas* and *Giancontierri*, it establishes when one or another type of meaning is legally effective. That rule of construction, in turn, tells

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[99] *Id.* at 779-80.

[100] *See generally* Joseph M. Perillo, *The Origins of the Objective Theory of Contract Formation and Interpretation*, 69 Fordham L. Rev. 427 (2000).

[101] Restatement (Second) of Contracts § 201(1) (1981). For a detailed account, see Lawrence M. Solan, *Contract as Agreement*, 83 Notre Dame L. Rev. 353 (2007).

adjudicators and others when to engage in what sort of interpretation when determining the legal effects of the parties' words and actions. If the pleadings or interpretation suggests that the parties' subjective understandings were in agreement, subjective meaning governs; if not, the objective meaning of their words and actions governs. Again, the correct approach to legal interpretation depends on a rule of construction. And that rule specifies that circumstances in which one or the other type of meaning controls.

3.3 Purpose

Rules of contract construction also sometimes condition legal outcomes on the purpose of an agreement or a term in it. The interpretation of purpose is somewhat different from the interpretation communicative meaning, be it plain meaning or use meaning. Purpose is more closely aligned with instrumental or practical reasoning. A party's purpose in entering into an agreement or agreeing to a term in it is the end she seeks to achieve. Although identifying an agreement's purpose requires understanding its communicative content, the rational reconstruction of reasons and motives plays a larger role. Interpreting an agreement's purpose is more like figuring out a tool's function by examining its parts. Although still a form of interpretation, the relevant evidence and inferences can differ from the interpretation of communicative meaning.

Section 202 of the Second Restatement, for example, provides a general rule of contract construction that emphasizes both use meaning and purpose: "Words and other conduct are interpreted in the light of all the circumstances, and if the principal purpose of the parties is ascertainable it is given great weight."[102] But the interpretation of purpose does not always require evidence of surrounding context. As observed above, purpose also figures into plain meaning rules. Thus the New York Court of Appeals has recently reaffirmed that "[a] written contract will be read as a whole, and every part will be interpreted with reference to the whole; and if possible it will be so interpreted as to give effect to its general purpose."[103]

An older New York case, *William C. Atwater & Co. v. Panama R. Co.*, further illustrates the role purpose plays in plain meaning rules. At issue was an installment contract for the sale of coal and the legal effect of the following provision: "Any portion of the tonnage remaining unshipped at the date of expiration of this agreement shall be considered cancelled without notice."[104] The sentence's literal meaning was that both parties would be released from liability for any coal unshipped by the end of the

[102] Restatement (Second) of Contracts § 202(1).
[103] Westmoreland Coal Co. v. Entech, Inc., 100 N.Y.2d 352, 358 (2003) (internal quotation marks omitted).
[104] 159 N.E. 418 (N.Y. 1927).

installment period. The buyer invoked the clause to attempt to avoid liability for coal that the seller chose not to ship due to the buyer's own refusal to accept earlier shipments. Reading the agreement as a whole, and in light of the seller's contractual option to reduce installments after a buyer breach, the Court of Appeals concluded that the clause's purpose was to cancel only installments unshipped as a result of the seller's exercise of that option. "Reason, equity, fairness—all such lights on the probably intention of the parties—show what the real agreement was."[105] Interpretation of the term's purpose required an imaginative reconstruction of what the parties sought to accomplish with it. *Atwater* stands for the proposition that the apparent purpose of a term can be legally controlling at the expense of the words' literal meaning.

In addition to its generic relevance, purpose figures into several more specific rules of contract construction. A defense of supervening frustration exists, for example, "[w]here after a contract is made, a party's principal purpose is substantially frustrated without his fault."[106] Article Two of the UCC provides that "[w]here circumstances cause an exclusive or limited remedy [such as liquidated damages] to fail of its essential purpose," the court may provide any other remedies available under the Code.[107] And though a commitment to serve as a surety is generally subject to the Statute of Frauds' writing requirement, where the surety's main purpose is a pecuniary or business advantage, the agreement falls outside the scope of the Statute.[108] Each is an example of an interpretive altering rule, for each specifies ways that the parties' or an agreement's purpose at the time of formation figures into determining the legal state of affairs, and the identification of purpose requires interpretation.

3.4 Intention and Belief

Yet other rules of contract law look to the parties' beliefs, intentions or other propositional attitudes.[109]

Implied-in-fact contracts provide a familiar example. Although contract law requires that each party agree to the transaction, it does not require that they express that agreement in so many words. "[W]here the parties do not explicitly manifest their intent to contract by words, their intent may be gathered by implication from their conduct, language, and

[105] *Id.* at 419.
[106] Restatement (Second) of Contracts § 265.
[107] U.C.C. 2-719(2).
[108] *See* Restatement (Second) of Contracts § 116.
[109] A propositional attitude is a mental state that takes as its object a proposition, and can therefore be described using a verb plus a "that" clause, as in, "She believed that . . ." or "They intended that . . ."

other circumstances attending the transaction."[110] When one party alleges an implied-in-fact contract, the question is not what the parties said, but what in the circumstances they objectively believed or intended. The ultimate question is not the meaning of their words, but their apparent intentions.

A common fact pattern illustrates. Suppose an individual submits a potentially valuable idea to a business, the business uses the idea, and the individual then demands payment. If the parties did not expressly agree to compensation, the law looks to their reasonable expectations. "[A]n implied in fact contract may be found when the parties have *an understanding* that the recipient of a valuable idea has accepted and used the idea, *knowing* that compensation *is expected* for use of the idea, without paying the purveyor of the idea."[111] This is an altering rule that determines when parties acquire contractual obligations. The dispositive question, however, is not the meaning of the parties said. It is, rather, what they objectively believed regarding the nature of the transaction.

Another group of examples can be found in formation rules that require that the parties intend legal liability. The black-letter law in most jurisdictions outside of the United States is that a contract exists only if, at the time of formation, the parties objectively intended that their agreement be legally binding.[112] Although US law generally eschews this requirement,[113] US courts condition the enforcement of some types of agreements on evidence of the parties' intent to be legally bound. Examples include preliminary agreements, agreements between family members and reporters' confidentiality promises.[114] Under all these rules the legal question is not the communicative content of the parties' words or actions—parties need not *say* that they intend legal liability—but the parties' apparent intentions.

Consider the rules for preliminary agreements. During the course of negotiations sophisticated parties sometimes write down the terms they have agreed to, though other terms remain under negotiation. Courts have

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[110] Featherston v. Steinhoff, 226 Mich. App. 584, 589 (1997).

[111] Wrench, LLC v. Taco Bell Corp., 51 F.Supp. 2d 840, ___ (D. Mich. 1999) (emphasis added), *reversed on other grounds*, 256 F.3d 446 (6th Cir. 2001).

[112] *See* The Commission of European Contract Law, Principles of European Contract Law arts. 2:101, 2:102 and accompanying notes (Ole Lando & Hugh Beale eds., 2000) (discussing European sources of law).

[113] *See* Restatement (Second) of Contracts § 21 (1981).

[114] *See, e.g.*, Teachers Ins. and Annuity Ass'n of Am. v. Tribune Co., 670 F. Supp. 491 (S.D.N.Y. 1987) (preliminary agreements); Empro Mfg. Co. v. Ball-Co Mfg., Inc., 870 F.2d 423 (7th Cir. 1989) (preliminary agreements); Restatement (Second) of Contracts § 21 cmt. c (1981) (agreements between family members); Cohen v. Cowles Media Co., 457 N.W.2d 199 (Minn. 1990) (reporter's confidentiality promise).

held that such preliminary agreements can create a legal duty to negotiate in good faith remaining open terms, but only if the parties intend the agreement to be legally binding. Thus in the seminal case of *Teachers Insurance and Annuity Association v. Tribune*, Judge Leval wrote:

> There is a strong presumption against finding binding obligation in agreements which include open terms, call for future approvals and expressly anticipate future preparation and execution of contract documents. Nonetheless, if that is what the parties intended, courts should not frustrate their achieving that objective or disappoint legitimately bargained contract expectations.[115]

This too is an altering rule. It determines when parties shift from not having a duty to negotiate in good faith to having such a duty. Although the rule turns on the parties' legal intent, it does not require that they *say* that they intend to be legally bound. It asks instead whether the parties *appear to intend* a legally binding agreement.[116] Thus in *Teachers Insurance*, Leval suggests a broad, all-things-considered inquiry into the parties objective intent, whose inputs include the language of agreement, the context of negotiations, the parties' motives, the number of open terms, the extent to which the agreement had been performed, and usage of trade.[117]

Both the rule for implied-in-fact contracts and the rule for preliminary agreements attach legal consequences to proof of one or both parties' beliefs or intentions. They are, therefore, interpretive altering rules. Some readers might find it a stretch to say that these mental states are part of the *meaning* of the parties' words and actions. But whether or not we call them "meaning," identifying the parties' beliefs, intentions or other legally salient propositional attitudes requires interpreting what they said and did. Attributing such mental states to others is a way of making sense of their behavior, linguistic and nonlinguistic.[118] This type of interpretation is not the same as the interpretation of communicative content, or even purpose. But it is a type of interpretation nonetheless, and is required by well-established rules of construction. The parties' propositional attitudes are yet

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[115] Teachers Ins. and Annuity Ass'n of Am. v. Tribune Co., 670 F. Supp. 491, 499 (S.D.N.Y. 1987).

[116] "In seeking to determine whether such a preliminary commitment should be considered binding, a court's task is, once again, to determine the intentions of the parties at the time of their entry into the understanding, as well as their manifestations to one another by which the understanding was reached." 670 F. Supp. at 499.

[117] 670 F. Supp. at 499–503.

[118] *See, e.g.*, Daniel C. Dennett, The Intentional Stance (1989); Donald Davidson, *Radical Interpretation*, *in* Inquiries into Truth and Interpretation 125 (1984).

another type of meaning that can, at times, be relevant to the determination of their contractual obligations.

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The above discussion illustrates two features of contract exposition. First, to paraphrase Sunstein, there is no one thing that contract interpretation just is. There are multiple types of legally salient contract interpretation. Whereas in public law there might be a need to choose one interpretive approach, the rules of contract construction call for different types of interpretation depending on the particulars of the case and the legal question at issue. Thus, for example, determining the legal effect of an unambiguous integrated document requires a different type of interpretation than interpreting an informal oral agreement, both of which differ from the interpretation needed to determine whether there exists a contract implied in fact.

The potential relevance of multiple types of meaning suggests also the possibility of a hierarchy of meanings. Thus plain meaning rules commonly permit recourse to extrinsic evidence of use meaning in cases of ambiguity. When plain meaning interpretation runs out, use meaning interpretation steps in. In explaining his constitutional originalism, Randy Barnett has suggested that "[w]hen original meaning runs out, constitutional 'interpretation,' strictly speaking, is over, and some new *noninterpretive* activity must supplement the information revealed by interpretation."[119] I doubt whether an originalist needs to agree with Barnett on this point. One might maintain that when a preferred form of original meaning—say original public meaning—does not decide a constitutional question, other types of constitutional meaning, and therefore other types of interpretation, should step in. But whether or not such a rule makes sense in constitutional law, multiple types of interpretation are the norm in the law of contracts. Contract interpretation need not end when one type of interpretation runs out.

Second, the above analysis demonstrates how legal interpretation stands in the service of construction. In order to determine what sort of interpretation is appropriate when, one needs a rule of construction. In the *process* of determining the legal effect of the parties' words or actions, interpretation comes first, construction second. But because legal interpretation is the handmaiden of construction, the rules of the former must satisfy the requirements of the latter. Rules of construction are *conceptually prior* to rules of legal interpretation.

The conceptual priority of construction and multiple types of meaning suggest that it is a mistake to attempt to argue for one or another

[119] Randy Barnett, *The Gravitational Force of Originalism*, 82 Fordham L. Rev. 411, 419 (2013) (emphasis added).

theory of contract interpretation based a theory of meaning more generally. Consider Corbin's argument against plain meaning rules:

> [I]t can hardly be insisted on too often or too vigorously that language at its best is always a defective and uncertain instrument, that words do not define themselves, that terms and sentences in a contract, a deed, or a will do not apply themselves to external objects and performances, that the meaning of such terms and sentences consists of the ideas that they induce in the mind of some individual person who uses or hears or reads them, and that seldom in a litigated case to the words of a contract convey one identical meaning to two contracting parties or to third persons. Therefore, it is invariably necessary, before a court can give any meaning to the words of a contract and can select one meaning rather than other possible ones as the basis for the determination of rights and other legal effects, that extrinsic evidence shall be heard to make the court aware of the "surrounding circumstances," including the persons, objects, and events to which the words can be applied and which caused the words to be used.[120]

Justice Traynor quotes the above passage in *Pacific Gas*.[121] There are clear echoes it in comments to the Second Restatement and the UCC.[122] And one finds similar claims in the writings of contemporary anti-formalists.[123] The claim is, in essence, that there is no such thing as plain meaning. "'[M]eaning' cannot exist without a speaker or hearer," and "no word or phrase has one true and unalterable meaning."[124] Meaning only happens

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[120] 3 Corbin (1st ed.) § 537 at ___.

[121] 442 P.2d at 644-45.

[122] Restatement (Second) of Contracts § 212 cmt. b (1981) ("meaning can almost never be plain except in a context"); U.C.C. § 2-202 cmt. 1 ("This section definitively rejects . . . [t]he premise that the language used has the meaning attributable to such language by rules of construction existing in the law rather than the meaning which arises out of the commercial context in which it was used.").

[123] *See, e.g.*, Melvin Aron Eisenberg, *The Emergence of Dynamic Contract Law*, *in* 2 Theoretical Inq. L. 1, 27 (2001) ("The proper interpretation of all purposive expressions, including contractual expressions, is necessarily dynamic, because the meaning of a purposive expression is always determined in part by its context, and the context is prior to the expression."); E. Allen Farnsworth, "*Meaning" in the Law of Contracts*, 76 Yale L.J. 939 (1967) (""The very concept of plain meaning finds scant support in semantics, where one of the cardinal teachings is the fallibility of language as a means of communication.").

[124] 3 Corbin (1st ed.) § 535, ___ n. 15 & ____.

when words are used in a particular setting for a specific purpose. The idea that words could have a meaning apart form their use is a form of magical thinking from another era.

This argument is confused. First, it employs an overly simplistic a theory of meaning. Plain meaning might not always capture what parties are doing with their words. But it is a type of meaning nonetheless. One can interpret words without knowing the full context of their use. Second, there are many different types of meaning that can be relevant in contract cases—plain and use, subjective and objective, an agreement's or term's purpose, and the parties' beliefs or intentions. Third, although the theory of language can tell us a great deal about how legal interpretation can work, it cannot tell us what form legal interpretation should take. A theory of language cannot tell us which type of interpretation best serves the policies and purposes behind the law of contract. For that we need a rule of construction.

4 The Interplay Between Interpretation and Construction

Part Three has demonstrated that the relationship between interpretation and construction is more complex than the supplemental conception recognizes. Although interpretation comes first in the process of exposition, the correct approach to interpretation depends on the relevant altering rule. Rules of construction are always conceptually prior to rules of legal interpretation. This Part identifies two other ways that construction sometimes precedes interpretation.

Describing them requires yet another distinction among types of meaning. Linguists and philosophers of language disagree about the best way to define "pragmatic" and "semantic" meaning.[125] Some describe the distinction in terms the types of evidence that goes into interpretation, others in terms of the question that the interpreter asks of that evidence. For my purposes, the latter approach is preferable and the following formulations serve well. The *pragmatic meaning* of an utterance or text is the best interpretation of the speaker's communicative intentions. Thus Kent Bach describes the ascription of pragmatic meaning as follows:

> The hearer . . . seeks to identify the speaker's intention in making the utterance. In effect the hearer seeks to explain the fact that the

[125] The topic is rich enough to the subject of at least one doctoral dissertation. Börjesson, Kristin. The Semantics-Pragmatics Controversy (2014). Robyn Carston identifies five separate ways scholars have tried to draw the distinction. Robyn Carston, *Linguistic Communication and the Semantics/Pragmatics Distinction*, 165 Synthese 321, 322 (2008). *See also* Kent Bach, *The Semantics/Pragmatic Distinction: What It Is and Why It Matters*, Linguistische Berichte, Sonderheft 8, 33 (1997).

> speaker said what he said, in the way he said it. Because the intention is communicative, the hearer's task of identifying it is driven partly by the assumption that the speaker intends him to do this. The speaker succeeds in communicating if the hearer identifies his intention in this way, for communicative intentions are intentions whose "fulfillment consists in their recognition."[126]

Semantic meaning, in distinction, is conventional meaning, which can be identified independently of the speaker's communicative intentions.[127] The semantic meaning of a sentence lies first and foremost in the conventional or literal meanings of its words, together with the rules of syntax or grammar of the language they belong to. It might also include contextual elements whose contribution to meaning is governed by determinate rules, such as those governing indexicals such as "I," "you" and "those."[128] Pragmatic meaning diverges from semantic meaning when speakers use their words in nonliteral ways. Familiar examples include irony, innuendo, metaphor, ellipsis, malapropism and the many forms of nonconventional conversational implicature.[129]

The distinction between pragmatic and semantic meaning does not map onto the various types of meaning and interpretation discussed in Part Three. For the most part, interpretive altering rules in the law of contract focus on the pragmatic meaning of what parties say and do—on the parties' apparent communicative intent. Thus the *Embry* court interpreted, "Go ahead, you're all right; get your men out and don't let that worry you," as an agreement to renew the contract, despite the words' literal meaning. The primacy of pragmatic meaning also explains why plain meaning is not always literal meaning. Where the literal meaning of an agreement is at odds with the agreement's apparent purpose when read as a whole, a court will treat the words as a slip of the pen and give legal effect to the pragmatic meaning of the parties' words at the expense of their semantic

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[126] Bach, *supra* note 125 at 41 (quoting Kent Bach & Robert M. Harnish, Linguistic Communication and Speech Acts 15 (1979)). The passage goes on to link this definition to the evidentiary conception of pragmatics. "Pragmatics is concerned with whatever information is relevant, over and above the linguistic properties of a sentence, to understanding its utterance." *Id*. Plain meaning rules demonstrate that the two conceptions of pragmatic meaning are not extensionally equivalent.

[127] This negative definition can be found in Kent Bach, Thought and Reference 180-181 (1987).

[128] *See* Bach *supra* note 125 at 37-40.

[129] *See* H.P. Grice, *Logic and Conversation*, *in* The Logic of Grammar 64 (Donald Davidson & Gilbert Harman eds., 1975), *reprinted in* Paul Grice, Studies in the Ways of Words 22 (1989); Bach & Harnish, *supra* note 126 at ___-___.

meaning. Thus on occasion, "'or' may be given the meaning of 'and,' or vice versa, if the remainder of the agreement shows that a reasonable person in the position of the parties would so understand it."[130]

Rules of construction can figure into the pragmatic meaning of what parties' say and do. This happens when parties choose their words in light of their legal consequences—in light of the altering rules that will determine their legal effect. Where this is the case, interpretation requires some understanding of the rules of construction the parties have in mind. I call this the "pragmatic priority" of construction. It is the topic of the second section of this Part.

If semantic meaning figures into contract law, it is primarily in formalistic altering rules. A formalistic altering rule does not require that parties utter words with the right meaning, but only that they use the right words. For example, the words "F.O.B." plus the name of a location suffices to determine the seller's responsibility for shipment and to allocate the risk of loss if goods are damages before arrival.[131] Formalistic altering rules attach conventional legal effects to certain words or acts, thereby giving them new semantic meanings. The first section of this Part discusses how acts of judicial construction can generate new formalistic altering rules, and thereby new semantic meanings. I call this the "semantic priority" of construction.

4.1 Acts of Construction and Semantic Priority

When during bidding a bridge player says, "Double," she is not using the word in its everyday sense. She is, rather, making a move in the game, effecting a change to how play will go forward. The rules of bridge give the ordinary word "double" a specialized function within that game. They give the word a new conventional, or semantic, meaning.

Formalistic altering rules similarly generate new semantic meanings. Consider again the legal use of "as is." The Uniform Commercial Code provides that "unless the circumstances indicate otherwise, all implied warranties are excluded by expressions like 'as is' [or] 'with all faults.'"[132] Although the rule is written as if the phrases were mere examples, in practice it establishes that these ordinary-language terms suffice to achieve a specific legal effect: excluding implied warranties.[133] Sophisticated parties

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[130] 2 Williston (1st ed.) § 619, 1199.

[131] U.C.C. § 2-319.

[132] U.C.C. § 2-316(3)(a).

[133] *See, e.g.,* Meyer v. Alex Lyon & Son Sales Managers & Auctioneers, Inc., 889 N.Y.S.2d 166 (1st Dept. 2009) (holding that "as is" clause disclaimed all implied warranties without further inquiry); Welwood v. Cypress Creek Estates, Inc., 205 S.W.3d 722 (Tex.App.—Dallas 2006) (same); Prudential Ins. Co. of America v. Jefferson Associates, Ltd., 896 S.W.2d 156 (Tex.

who encounter "as is" in a contract know that it is not being used to convey its non-legal meaning (arguably a tautology), but is there solely to achieve a specific legal effect. The formalistic altering rule gives the word a new semantic meaning.

Legal formalities come from a variety of sources. A statute might create a formality by fiat. Or it might codify historical patterns of use and legal effect among the legal community. Especially interesting for my purposes, and highly salient to the law of contracts, is the fact that acts of judicial construction can give a string of words a standard legal effect, thereby creating a new formality.

For several centuries, the standardized language in a Lloyd's marine insurance policy used the following words to describe covered risks:

> Touching the Adventures and Perils which we the Assurers are contented to bear and do take upon us in this Voyage, they are, of the Seas, Men-of-War, Fire, Enemies, Pirates, Rovers, Thieves, Jettisons, Letters of Mart and Counter-mart, Surprisals, Takings at Sea, Arrests, Restraints and Detainments of all Kings, Princes, and People, of what Nation, Condition or Quality soever, Barratry of the Master and Mariners, and of all other Perils, Losses and Misfortunes that have or shall come to the Hurt, Detriment, or Damage of the said Goods and Merchandises and Ship, &c., or any Part thereof.[134]

In his 1914 treatise, Sir Douglas Owen observed that "[i]f such a contract were to be drawn up for the first time to-day, it would be put down as the work of a lunatic endowed with a private sense of humour."[135] But the "Adventures and Perils" clause in fact had an established set of legal consequences:

> It is an ancient and incoherent document, occasionally the subject of judicial remarks in the highest degree uncomplimentary. But nobody minds this or dreams of altering the ancient form, nor, one may imagine, is it ever likely to be altered. Insurance experts know—or very often know—exactly what it means, and with generations of legal interpretations hanging almost to every word, and almost certainly to every sentence, in it, it would be highly dangerous to tamper with it.[136]

1995) (same); Warner v. Design and Build Homes, Inc., 114 P.3d 664 (Wash.App. Div. 2 2005) (same).

[134] I am grateful to Jim Oldham for bringing this example to my attention. *See* James C. Oldham, *Insurance Litigation Involving the Zong and other British Slave Ships*, 1780-1807, 28 J. Legal Hist. 299, 300 (2007).

[135] Sir Douglas Owen, Ocean Trade and Shipping 158 (1914).

[136] *Id*. at 155.

Lloyd's "Adventures and Perils" clause was a legal formality. Years of judicial construction gave the clause a standard legal effect, thereby generating a formalistic altering rule. That rule, in turn, gave the clause a new conventional, or semantic, meaning.

I call this the "semantic priority" of construction. The semantic priority of construction is a type of etymological priority. Judicial construction of nontechnical words can give those words new conventional legal meanings going forward. Construction can transform ordinary words into legal formalities.

The semantic priority of construction is a contingent feature of the legal system we have. If judicial construction sometimes generates new formalities, it is only because judicial decisions are both backward and forward looking. When a text's legal effect of is at issue, the court's job is to construe the effects of the words that appear in it. As Lawrence Solum puts the point, the question concerns a particular tokening of those words.[137] At the same time, principles of *stare decisis* mean that this backward-looking decision can have forward-looking legal effects. The decision can also determine the legal consequences of future uses of the type.

But principles of *stare decisis* alone do not explain the semantic priority of construction in contract cases. It is a familiar fact that the same words often acquire different shades of meaning in different circumstances. If the fundamental principle of contract exposition is to ascertain the parties' intentions, it is not obvious why the construction of words in one contractual agreement should ever govern the construction of that same words in a different one.

There is, however, an instrumental advantage to that result. Formalities provide sophisticated parties cheap and effective tools with which to achieve the legal effects they want. As Lon Fuller observed, "form offers a legal framework into which the party may fit his actions, or, to change the figure, it offers channels for the legally effective expression of intention."[138] Interpretive inquiries into parties' intentions can be uncertain and their results difficult to predict. By rendering interpretation unnecessary, a formality gives sophisticated parties an instrument for realizing those intentions. Allowing the construction of a string of words in one agreement to govern the construction of the same words in other agreements is a way of generating new, potentially useful formalities.

And in fact, the Second Restatement authorizes this result. Section 212(2) provides that when a party adopts a writing knowing that it is the standard form for a transaction, the writing "is interpreted wherever

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[137] Lawrence B. Solum, *The Fixation Thesis: The Role of Historical Fact in Original Meaning*, 1 Notre Dame L. Rev. 1, 35-41 (2015).
[138] Lon L. Fuller, *Consideration and Form*, 41 Colum. L. Rev. 799, 801 (1941).

reasonable as treating alike all those similarly situated, without regard to [the parties'] knowledge or understanding of the standard terms of the writing."[139] Although the Restatement uses the word "interpret," section 211(2) is a rule of construction. It tells courts to treat boilerplate as having the same legal effect across multiple transactions, even if those transactions involve different parties with different background and occur in different circumstances. The rule authorizes the creation of new formalities by way of the judicial construction of contractual agreements. The reason for the rule is the practical advantages of contract formalities.

The danger of legal formalities, of course, is that unsophisticated parties might not understand the legal effects of their words or actions. A buyer who does not know the legal meaning of "as is" might not understand what she is getting in a sale. The danger is especially salient when it comes to judicially generated boilerplate formalities.

Consumer insurance law provides an example. Many courts today apply the doctrine of reasonable expectations: "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."[140] The doctrine of reasonable expectations is another rule of construction that authorizes courts to give a clause a legal effect that departs from its plain meaning, thereby creating a gap between the best interpretation of a contractual agreement and the parties' legal obligations.

The doctrine's become more interesting when later courts apply the same construction to other contracts, in accordance with the principle of section 211(2). At this point the clause at issue has become a formality. But because the formality originated in an application of the doctrine of reasonable expectations, its conventional legal meaning cannot be found in the contract language. As Michelle Boardman observes, the result is that "[b]oilerplate that has repeatedly been construed by courts will take on a set, common meaning [*i.e.*, legal effect], but one that may not be easily understood by reading the language itself."[141] Thus applications of a rule of

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[139] Restatement (Second) of Contracts § 211(2) (1981).

[140] Robert E. Keeton, Insurance Law Rights at Variance with Policy Provisions, 83 Harv. L. Rev. 961, 967 (1970). Keeton's article was the first to articulate the principle, based on his collection of cases. For discussions of subsequent developments in the doctrine, see Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 Va. L. Rev. 1151 (1981); Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law After Two Decades*, 51 Ohio St. L.J. 823 (1990); Peter Nash Swisher, *A Realistic Consensus Approach to the Insurance Law Doctrine of Reasonable Expectations*, 35 Tort & Ins. L.J. 729 (2000).

[141] *Id.* at 1111.

construction that is intended to protect insureds—the doctrine of reasonable expectations—can generate legal formalities that unsophisticated insureds are unlikely to understand. "[A]n outside reader may have an illusion of understanding, but only knowledge of the subsequent case law and regulatory actions can reveal what the language means in the eyes of the law."[142] Insofar as the semantic priority of construction operates to give words, phrases or entire clauses conventional legal meanings that significantly diverge from their nonlegal meanings, it can also function to mislead unsophisticated parties.

Although contract scholars have written a great deal about the advantages and disadvantages of plain meaning rules—what one might call "interpretive formalism"—they have paid less attention to the potential utility and possible downsides of formalities—what might be called "noninterpretive formalism."[143] We do not have a general theory of when formalities add value, of their optimal design, or of how to generate new formalities. Such a theory would assess *inter alia* the costs and benefits of the production of formalities through acts of judicial construction and section 211(2) in various types of contracts. Such a theory is beyond the scope of this work. For present, it is enough to observe the phenomenon and the potential semantic priority of acts of judicial construction.

4.2 Rules of Construction and Pragmatic Priority

Although the application of a formalistic altering rule does not itself require interpretation, the rule itself can give words new conventional meanings. Construction is semantically prior to interpretation when individual acts of judicial construction generate new formalities, which is to say, when they produce new formalistic altering rules.

The pragmatic priority of construction, in distinction, appears in the interpretation of certain legal acts. It follows from the fact that parties often take rules of construction into account when choosing their words. When this is so, on order to identify the parties' communicative intent—the pragmatic meaning of their words—one needs to know something about the altering rule they mean to satisfy.

Consider the communicative intent of the following provision in a negotiated written agreement between sophisticated parties:

> This instrument embodies the whole agreement of the parties. There are no promises, terms, conditions, or obligations other than those contained in this contract, and this contract shall supersede all

[142] *Id.*

[143] Ian Ayres is an exception. *See* Ayres, *supra* note 4 at 2080-83.

> previous communications, representations, or agreements, either verbal or written, between the parties.[144]

The provision is an integration clause. Without saying so explicitly, it expresses the parties' shared intent that the writing be treated as integrated under the parol evidence rule, with the legal effect of excluding extrinsic evidence of contrary or additional terms. As discussed above, the parol evidence rule is a type of altering rule. It allows parties to change the default rules of construction that apply to their agreement. Familiarity with that altering rule is essential to identifying the communicative intent of such an integration clause.

I call this the "pragmatic priority" of construction. Construction is *pragmatically prior* to interpretation when a speaker intends her speech act to satisfy, to conform to, or to avoid a rule of construction. When this is the case, one cannot identify the pragmatic meaning of the speaker's words or actions without knowing something about that rule of construction.

The pragmatic priority of construction is integral to formation rules that require that parties intend legal liability. Recall the rule for preliminary agreements: a preliminary agreement creates a duty to negotiate only if the parties intended it to be legally binding. Such an intent presupposes a rule of construction that gives that intent legal effect. Its interpretation therefore also presupposes awareness of that rule of construction. The rule of construction is pragmatically prior to the intent to effect a legal change.

Intent-to-contract rules are the most obvious, but by no means the only examples of the pragmatic priority of construction. Contractual agreements between sophisticated parties often include clauses intended to effect one or another legal change. In addition to integration clauses, examples include warranty limitations and non-reliance clauses; material adverse change clauses in merger or acquisition agreements; provisions in consumer contracts that permit unilateral modification with notice; remedial clauses such as damage limitations or liquidated damages clauses; and choice of law, choice of forum and arbitration clauses. In order to identify the communicative intent of any such clause—in order to interpret its pragmatic meaning—one must know something about contract law. More specifically, one must know that there perhaps exists an altering rule that the parties' intend their words to satisfy.[145]

The above examples involve contractual agreements that aim to achieve specific legal effects. Rules of contract construction can also figure more globally into how parties speak. Legal actors often choose their words in light of the legal rules they expect to determine their legal effect. Williston suggests an example.

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[144] 1A Williston on Contracts 4th Forms § 33F:2 (2016).

[145] "Perhaps exists" because the parties might intend to exercise a power they do not have.

> In an ordinary oral contract or one made by correspondence, the minds of the parties are not primarily addressed to the symbols which they are using; they are considering the things for which the symbols stand. Where, however, they incorporate their agreement into a writing they have attempted more than to assent by means of symbols to certain things, they have assented to the writing as the adequate expression of the things to which they agree.[146]

Williston posits here that when parties agree to an integrated writing, they expect it to be construed according to its plain meaning, and that their communicative intentions and choice of words presuppose that rule of construction. As an argument for the plain meaning rule, this suffers from circularity. Because sophisticated parties' expectations depend on what the legal rule is, those expectations cannot serve as a reason to choose one rule over another. But as an analysis of parties' communicative intentions when contracting in the shadow of a plain meaning rule, it reveals an important truth. Sophisticated parties take rules of construction into account when choosing how to speak.[147] The interpretation of their communicative intentions—of the pragmatic meaning of their words and actions—also must take account of the salient rules of construction and their effect on what those parties say and do.

Public law theorists have recognized something like the last point. William Eskridge and John Ferejohn's anticipation-response theory argues that legislators and legislative staff often anticipate judicial construction of the legislation they produce, and that committee reports and floor debates should be interpreted accordingly.[148] And John McGinnis and Michael Rappaport have argued for an "original methods originalism" that would take account of the rules of constitutional construction in effect at the time of the Constitutional Convention and subsequent ratification, on the theory that the framers and ratifiers would have themselves taken those rules into

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[146] 2 Williston (1st ed.) § 606, 1165.

[147] The same observation lies behind familiar arguments, often advanced by those who employ economic analysis, that plain meaning rules give parties a new reason to invest in expressing their intentions in clear language. *See, e.g.*, Schwartz & Scott, *supra* note 48 at 572. It is also appears in Jody Kraus and Robert Scott's idea of intended contractual means, as distinguished from contractual ends. Jody S. Kraus & Robert E. Scott, *Contract Design and the Structure of Contractual Intent*, 84 N.Y.U. L. Rev. 1023, 1026 (2009).

[148] *See* Victoria Nourse, *A Decision Theory of Statutory Interpretation: Legislative History by the Rules*, 122 Yale L.J. 70, 143-47 (2012) (discussing William N. Eskridge, Jr. & John Ferejohn, *The Article I, Section 7 Game*, 80 Geo. L.J. 523 (1992)).

account when they assigned meaning to the constitutional text.[149] More generally, because public lawmakers intend their words to effect a legal change, lawmakers are likely to chose them with some attention to the rules of construction that secure that effect. One might therefore expect the pragmatic priority of construction to be ubiquitous in public law.[150]

The situation is different in the law of contracts. Although rules of construction are sometimes pragmatically prior to contract interpretation, they are not always so. The question is an empirical one and depends both on the rule of construction at issue and on the responsiveness of legal actors to it. Consider the UCC rule for express warranties:

> Any affirmation of facts . . . which relates to the goods and becomes part of the basis of the bargain creates an express warranty. . . . It is not necessary to the creation of an express warranty that the seller use formal words such as 'warrant' or 'guarantee' or that he have a specific intention to make a warranty.[151]

An "affirmation of fact" is not a legal act, and might be made without any awareness of the legal consequences. The requisite altering act does not presuppose awareness of the altering rule. More generally, though contracting parties often intend the legal effects of their words, many contract altering rules do not require such an intent. Corbin suggests another helpful example, involving formation rules.

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[149] John O. McGinnis & Michael B. Rappaport, *Original Methods Originalism: A New Theory of Interpretation and the Case Against Construction*, 103 Nw. U.L. Rev. 751 (2009).

[150] That said, even in the context of public lawmaking responsiveness to relevant rules of construction is a question of fact. A legislator might know that she is making a law without knowing all the rules of construction that will determine the legal effects of her words and actions. Victoria Nourse has argued, for example, that "[t]here are good empirical reasons to believe that members of Congress are indifferent to the vast majority of ordinary statutory interpretation cases in appellate courts." Nourse, *supra* note 148 at 144. And several studies by Abbe Gluck and Lisa Bressman indicate that the congressional staffers who write federal legislation do not fully understand the cannons of statutory interpretation and construction courts will use to give legal effect to the statutes they draft. Abbe R. Gluck & Lisa Schultz Bressman, *Statutory Interpretationfrom the Inside- An Empirical Study of Congressional Drafting, Delegation, and the Canons: Part I*, 65 Stan. L. Rev. 901 (2013). Even in public lawmaking, legal actors only sometimes take rules of construction into account when choosing their words.

[151] U.C.C. § 2-314(1)(a) & (2).

> There seems to be no serious doubt that a mutual agreement to trade a horse for a cow would be an enforceable contract, even though it is made by two ignorant persons who never heard of a legal relation and who do not know that society offers any kind of a remedy for the enforcement of such an agreement.[152]

Because the rules of contract formation do not require that parties intend or expect the legal consequences of their acts, parties can enter a contract without intending to do so. In such cases, their communicative intentions do not incorporate the altering rules that give their words legal effect. When parties do not intend or expect a legal change, interpreting their communicative intent does not require an understanding the relevant rule of construction.

Acts of public lawmaking are juristic acts, or what German private law calls "Rechtsgeschäfte" in civil law contexts.[153] A juristic act is a speech act that expresses the speaker's or author's intent to effect a legal change by the very expression of that intent.[154] Thus the pervasive pragmatic priority of authorizing rules—or rules of construction—in acts of public lawmaking. The communicative content of juristic acts includes the intent to effect a legal change, and therefore to satisfy an altering rule. The acts that generate and alter contractual obligations, in distinction, need not be juristic acts—though they sometimes are. Rules of construction are only sometimes pragmatically prior to contract interpretation, but not always and not pervasively.[155]

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[152] 1 Corbin (1st ed.) § 34 at 135. The Second Restatement suggests another example:

> A orally promises to sell B a book in return for B's promise to pay $5. A and B both think such promises are not binding unless in writing. Nevertheless there is a contract, unless one of them intends not to be legally bound and the other knows or has reason to know of that intention.

Restatement (Second) of Contracts § 21 ill. 2 (1981)

[153] The idea of a juristic act is relatively unfamiliar in contemporary Anglo-American legal theory, but is important enough in German private law that Werner Flume gives it a full volume of his four volumes on the German Civil Code. Werner Flume, 2 Allgemeiner Teil des Bürgerlichen Rechts: Das Rechtsgeschäft (1992). The category of juristic acts is central to Wigmore's account of the parol evidence rule. 5 John Henry Wigmore, A Treatise on the Anglo-American Law of Evidence in Trials at Common Law, § 2401, 238 (2d ed. 1924) (describing the category of "jural acts").

[154] For more on juristic acts, see the discussion of power conferring rules in Gregory Klass, *Three Pictures of Contract: Duty, Power and Compound Rule*, 83 N.Y.U. L. Rev. 1726, 1740-42 (2008).

[155] For more on this point, see *id.* (*passim*).

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Although a complete theoretical account of the semantic and pragmatic priorities of construction is fairly complex, each reflects a familiar fact: authoritative judicial decisions can give words new legal meanings, and legal actors often take into account the legal effects of their words and actions when deciding what to say or do. When either happens, construction can figure into the meaning of legal actors' words and actions. Interpretation must take account of both any acts of construction that give words conventional legal meanings (semantic priority) and the rules of construction that the legal actors might have in mind (pragmatic priority). Another way of putting this is that construction is not exogenous to meaning. It does not stand outside of legal actors' intentions or the language they use.

Conclusion

In order to understand how contract law translates parties' words and actions into legal obligations, permissions, powers and other relations, it is important to distinguish two activities: interpretation, which is the determination of the meaning of the parties' words and actions, and construction, which determines their legal effect.

Interpretation is the application of the interpreters' linguistic abilities and social knowledge to identify the meaning of parties' words and actions. There are, however, multiple types of meaning, and therefore multiple types of interpretation. Depending on the facts of the transaction and the legal question, the existence or content of a contract might turn on the plain meaning of a writing, on the contextually determined use meaning of the parties' words and actions, on subjective or objective meaning, on the purpose of the agreement or a term in it, or on the parties' beliefs and intentions. Contract interpretation can involve the identification of any of these types of meaning.

Which type of meaning is legally relevant when depends on the applicable rule of construction. More specifically, it turns on the relevant altering rule. Altering rules specify who must do what to effect a legal change. Interpretive altering rules require that parties say or do something with the right meaning. Interpretation enters the contract exposition through interpretive altering rules.

But not all contract altering rules look to the meaning of the parties' words and actions. Formalistic rules condition legal outcomes on acts of the right form, without regard to their nonlegal meaning.

Although interpretation precedes construction in the order of exposition, there are three other senses in which construction can be prior to interpretation. First, legal interpretation always serves construction. What counts as the correct approach to interpretation therefore depends on the

applicable rule of construction. Second, individual acts of construction, including the application of interpretive altering rules, can in our system produce new legal formalities. Acts of construction can thereby give words new semantic meanings. Finally, because contracting parties act in the shadow of the rules of construction that will give their actions legal effect, it is sometimes impossible to understand the meaning of what they say and do without knowing something about the altering rules they intend to satisfy or avoid. This is the pragmatic priority of construction.

This Article's approach has been descriptive and analytic. I have not discussed when the contract law should attend to one or another type of meaning or the factors that go into choosing one or another interpretive approach. Nor have I examined the costs and benefits of adding formal components to interpretive altering rules, the choice between interpretive and formalistic altering rules, or how the law should go about recognizing new formalities. These design questions are important. But before addressing them, one must be have a clear understanding of the toolkit lawmakers have at their disposal. That has been the project of this Article.

Section 5-701

Agreements required to be in writing

General Obligations (GOB)

a. Every agreement, promise or undertaking is void, unless it or some note or memorandum thereof be in writing, and subscribed by the party to be charged therewith, or by his lawful agent, if such agreement, promise or undertaking:

1. By its terms is not to be performed within one year from the making thereof or the performance of which is not to be completed before the end of a lifetime;

2. Is a special promise to answer for the debt, default or miscarriage of another person;

3. Is made in consideration of marriage, except mutual promises to marry;

5. Is a subsequent or new promise to pay a debt discharged in bankruptcy;

6. Notwithstanding section 2-201 of the uniform commercial code, if the goods be sold at public auction, and the auctioneer at the time of the sale,

enters in a sale book, a memorandum specifying the nature and price of the property sold, the terms of the sale, the name of the purchaser, and the name of the person on whose account the sale was made, such memorandum is equivalent in effect to a note of the contract or sale, subscribed by the party to be charged therewith;

9. Is a contract to assign or an assignment, with or without consideration to the promisor, of a life or health or accident insurance policy, or a promise, with or without consideration to the promisor, to name a beneficiary of any such policy. This provision shall not apply to a policy of industrial life or health or accident insurance.

10. Is a contract to pay compensation for services rendered in negotiating a loan, or in negotiating the purchase, sale, exchange, renting or leasing of any real estate or interest therein, or of a business opportunity, business, its good will, inventory, fixtures or an interest therein, including a majority of the voting stock interest in a corporation and including the creating of a partnership interest. "Negotiating" includes procuring an introduction to a party to the transaction or assisting in the negotiation or consummation of the transaction. This provision shall apply to a contract implied in fact or in law to pay reasonable compensation but shall not apply to a contract to pay compensation to an auctioneer, an attorney at law, or a duly licensed real estate broker or real estate salesman.

b. Notwithstanding paragraph one of subdivision a of this section:

1. An agreement, promise, undertaking or contract, which is valid in other respects and is otherwise enforceable, is not void for lack of a note, memorandum or other writing and is enforceable by way of action or defense provided that such agreement, promise, undertaking or contract is a qualified financial contract as defined in paragraph two of this subdivision and (a) there is, as provided in paragraph three of this subdivision, sufficient evidence to indicate that a contract has been made,

or (b) the parties thereto, by means of a prior or subsequent written contract, have agreed to be bound by the terms of such qualified financial contract from the time they reach agreement (by telephone, by exchange of electronic messages, or otherwise) on those terms.

2. For purposes of this subdivision, a "qualified financial contract" means an agreement as to which each party thereto is other than a natural person and which is:

(a) for the purchase and sale of foreign exchange, foreign currency, bullion, coin or precious metals on a forward, spot, next-day value or other basis;

(b) a contract (other than a contract for the purchase and sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade) for the purchase, sale or transfer of any commodity or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or any product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into;

(c) for the purchase and sale of currency, or interbank deposits denominated in United States dollars;

(d) for a currency option, currency swap or cross-currency rate swap;

(e) for a commodity swap or a commodity option (other than an option contract traded on, or subject to the rules of a contract market or board of trade);

(f) for a rate swap, basis swap, forward rate transaction, or an interest rate option;

(g) for a security-index swap or option or a security (or securities) price

swap or option;

(h) an agreement which involves any other similar transaction relating to a price or index (including, without limitation, any transaction or agreement involving any combination of the foregoing, any cap, floor, collar or similar transaction with respect to a rate, commodity price, commodity index, security (or securities) price, security-index or other price index);

(i) for the assignment, sale, trade, participation or exchange of indebtedness or claims relating thereto arising in the course of the claimant's business or profession (including but not limited to commercial and/or bank loans, choses in action arising under or in connection with loan agreements and private notes, and including forward sales), but only to the extent that such indebtedness or obligation was not incurred by a natural person primarily for personal, family or household purposes; or

(j) an option with respect to any of the foregoing.

3. There is sufficient evidence that a contract has been made if:

(a) There is evidence of electronic communication (including, without limitation, the recording of a telephone call or the tangible written text produced by computer retrieval), admissible in evidence under the laws of this state, sufficient to indicate that in such communication a contract was made between the parties;

(b) A confirmation in writing sufficient to indicate that a contract has been made between the parties and sufficient against the sender is received by the party against whom enforcement is sought no later than the fifth business day after such contract is made (or such other period of time as the parties may agree in writing) and the sender does not receive, on or before the third business day after such receipt (or such other period of time as the parties may agree in writing), written objection to a material

term of the confirmation; for purposes of this subparagraph, a confirmation or an objection thereto is received at the time there has been actual receipt by an individual responsible for the transaction or, if earlier, at the time there has been constructive receipt which is the time actual receipt by such an individual would have occurred if the receiving party, as an organization, has exercised reasonable diligence; and a "business day" for the purposes of this subparagraph is a day on which both parties are open and transacting business of the kind involved in that qualified financial contract which is the subject of the confirmation;

(c) The party against whom enforcement is sought admits in its pleading, testimony or otherwise in court that a contract was made; or

(d) There is a note, memorandum or other writing sufficient to indicate that a contract has been made, signed by the party against whom enforcement is sought or by its authorized agent or broker.

For purposes of this paragraph evidence of an electronic communication indicating the making therein of a contract or a confirmation, admission, note, memorandum or writing is not insufficient because it omits or incorrectly states one or more material terms agreed upon, so long as such evidence provides a reasonable basis for concluding that a contract was made.

4. For purposes of this subdivision, the tangible written text produced by telex, telefacsimile, computer retrieval or other process by which electronic signals are transmitted by telephone or otherwise shall constitute a writing and any symbol executed or adopted by a party with the present intention to authenticate a writing shall constitute a signing. The confirmation and notice of objection referred to in subparagraph (b) of paragraph three of this subdivision may be communicated by means of telex, telefacsimile, computer or other similar process by which electronic signals are transmitted by telephone or otherwise, provided that a party claiming to

have communicated in such a manner shall, unless the parties have otherwise agreed in writing, have the burden of establishing actual or constructive receipt by the other party as set forth in subparagraph (b) of paragraph three of this subdivision.

UP ONE LEVEL
TITLE 7
Requirements Of Writing, Execution Or Acknowledgment For Effectiveness Or Enforceability (/Legislation/laws/GOB/A5T7)

NEXT
SECTION 5-702
Requirements For Use Of Plain Language In Consumer Transactions (/Legislation/laws/GOB/5-702/)

Freiberger Haber LLP Court Excludes Parol Evidence Where Contract Is Complete, Clear And Unambiguous

Posted on: Aug 21 2017

The foundation of virtually every business and commercial transaction is a contract. Indeed, it is hard to imagine any transaction for the purchase or sale of goods, the merger or acquisition of a business, or the provision of services that is not founded upon a contract.

There is almost nothing more frustrating, or potentially costlier, to businesses and commercial practitioners than a dispute over the meaning of a contract. Such disputes often arise over the performance or non-performance of a term in the contract.

The dispute as to the meaning of a contract can take many forms. It may be that the language used is ambiguous; or the language is reasonably clear but is susceptible to different meanings; or although the language is clear, taken literally, it might not reflect the parties' intent; or, as is often the case, an event has occurred that was not contemplated by the parties at the time of drafting, so the contract does not

specifically provide for it.

When parties enter into a contract, each assumes that the language in their agreement accurately memorializes their understandings and intentions. For this reason, when a dispute arises, the courts in New York look to the intent of the parties as expressed by the language they chose to put into their writing. *Ashwood Capital, Inc. v. OTG Mgt., Inc.*, 99 A.D.3d 1 (1st Dept. 2012). A clear, complete document will be enforced according to its terms. *Id*. at 7.

When the parties have a dispute over the meaning of their contract, the court first asks if the contract contains any ambiguity. *Id*. Since New York is a textual jurisdiction (where the courts look to the agreement itself to determine the meaning of the agreement), whether there is ambiguity "is determined by looking within the four corners of the document, not to outside sources. *Kass v. Kass*, 91 N.Y.2d 554, 566 (1998). Thus, courts will examine the parties' intentions as set forth in the agreement and seek to afford the language an interpretation that is sensible, practical, fair, and reasonable. *Riverside S. Planning Corp. v. CRP/Extell Riverside, L.P.*, 13 N.Y.3d 398, 404 (2009); *Abiele Contr. V. New York City School Constr. Auth.*, 91N.Y.2d1, 9-10 (1997); *Brown Bros. Elec. Contr. v. Beam Constr. Corp.*, 41 N.Y.2d 397, 400 (1977).

A contract is not ambiguous if, on its face, it is definite and precise and reasonably susceptible to only one meaning. *White v. Continental Cas. Co.*, 9 N.Y.3d 264, 267 (2007). The "parties cannot create ambiguity from whole cloth where none exists, because provisions are not ambiguous merely because the parties interpret them differently." *Universal Am. Corp. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 25 NY3d 675, 680 (2015) (citation and internal quotation marks omitted).

"Whether or not a writing is ambiguous is a question of law to be resolved by the courts." *WWW Assocs., Inc. v Giancontieri*, 77 N.Y.2d 157, 162 (1990). "[E]xtrinsic and parol evidence is not admissible to create an ambiguity in a written agreement which

is complete and clear and unambiguous upon its face." *Id*. at 163. This rule is especially applicable where the parties are commercially sophisticated and their contract contains a merger clause. *Schron v. Troutman Sanders LLP*, 20 N.Y.3d 430, 436 (2013) ("where a contract contains a merger clause, a court is obliged to require full application of the parol evidence rule in order to bar the introduction of extrinsic evidence to vary or contradict the terms of the writing.") (citation and quotation marks omitted).

Finally, since a "contractual provision that is clear on its face must be enforced according to the plain meaning of its terms," *Bank of N.Y. Mellon v. WMC Mortg., LLC*, 136 A.D.3d 1, 6 (1st Dept. 2015) (citation omitted), courts may not "add or excise terms, nor distort the meaning of those used and thereby make a new contract for the parties under the guise of interpreting the writing." *Id*. (citations omitted). This is especially so "in commercial contracts negotiated at arm's length by sophisticated, counseled business people." *Id*.

Hoeg Corporation v. Peebles Corporation

These principle were at play recently in *Hoeg Corp. v. Peebles Corp.*, 2017 NY Slip Op. 06066 (2d Dept. Aug. 9, 2017). There, the Second Department ruled that the contract before it was clear, complete and unambiguous and, therefore, should have been enforced according to its terms.

Background

Hoeg arose from a dispute over a contract concerning a joint venture the parties formed in May 2012. The venture came about in December 2011, when Hoeg contacted Peebles about the possibility of forming the relationship for the purpose of responding to requests for proposals from the New York City Economic Development Corporation ("EDC"). Thereafter, the parties entered into a written retainer agreement in May 2012 (the "Retainer Agreement"), setting forth the terms of their relationship and, *inter alia*, the compensation to be paid to the plaintiff.

Hoeg alleged that, notwithstanding the written Retainer Agreement, it had earlier entered into a separate oral agreement with Peebles for the joint venture wherein the equity would be split 75%/25% in favor of Peebles. Hoeg filed suit asserting, *inter alia*, that Peebles breached that oral agreement.

According to Hoeg, after Peebles used it to win a bid to purchase and develop an EDC property and ultimately sold the development rights to that property in a multimillion dollar deal, Peebles failed to honor the terms of the oral agreement. Peebles moved to dismiss. Relying on parol evidence, the motion court granted Peebles' motion. The Second Department reversed.

The Court's Ruling

The Court held that the motion court should have granted Peebles's motion to dismiss the breach of contract claim.

The Court found that the written Retainer Agreement was “a complete written instrument," which prohibited the motion court from considering “evidence of what may have been agreed orally between the parties prior to the execution of this integrated written instrument."

The Court held that because the written Retainer Agreement “was comprehensive in its scope and coverage," the motion court should not have received parol evidence “to vary the terms of the writing." The Court explained:

> The written retainer agreement provided that the plaintiff would act as a consultant in order to facilitate the defendant's acquisition and development of real property in New York City. The written retainer agreement did not limit its application to any particular project or property, or carve out any exceptions to the plaintiff's full-time dedication to the purpose of the agreement. The written retainer agreement also set forth different commission structures for work

> performed by the plaintiff in facilitating the defendant's acquisition and development of certain specified properties in Harlem, as well as the acquisition and development of properties other than the specified Harlem properties. Additionally, the written retainer agreement provided for the reimbursement of all expenses incurred by the plaintiff in connection with any work performed by the plaintiff on the defendant's behalf.... Thus, the documentary evidence submitted by the defendant conclusively disposed of the plaintiff's claim alleging breach of the purported oral joint venture agreement.

Citation omitted.

Takeaway

Hoeg is yet another case in a long line of New York cases that stand for the proposition that a written agreement, which is complete, clear, and unambiguous on its face, must be enforced to give effect to the meaning of its terms, even in the absence of a merger clause. (This Blog recently discussed merger clauses and their effect on contract interpretation here.) As *Hoeg* demonstrates, a contract is considered to be complete, clear and unambiguous where the language used has a definite and precise meaning, unaccompanied by the risk of misconception in the language of the agreement itself, and where there is no reasonable basis for a difference of meaning or opinion. Thus, as Hoeg learned, parol evidence of a communication made during negotiations of the written agreement that contradicts, varies, or explains the agreement or a term therein cannot be used to vary or contradict the terms of that writing.

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