The Feasibility Study’s Rules on Contract Interpretation*

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In this paper, I use an economic approach to analyse the rules on contract interpretation of the Feasibility Study for a Future Instrument in European Contract Law (hereinafter ‘Feasibility Study’). The main findings of this paper are twofold. First, assuming that primarily (medium-sized) firms in international transactions will choose the Feasibility Study to govern their contract, the subjective (or contextual) approach of Article 56 of the Feasibility Study should not have been chosen as the default. Firms typically prefer courts to adhere as closely as possible to the ordinary meaning of the words in the agreement. That is to say, firms typically prefer the textualist (or objective) approach. The textualist theory will not always suit contracting parties. Therefore, parties should have the possibility to contract around the textualist default. Second, Article 57 of the Feasibility Study is less advantageous for contracting parties. In principle – assuming again that primarily (medium-sized) firms in international transactions will choose the Feasibility Study to govern their contract – courts should use narrow evidentiary bases when interpreting contracts. However, courts should also comply with party requests to broaden the base that is applicable to them.


Deuxièmement, l’article 57 de l’Etude de Faisabilité est moins avantageux pour les parties contractantes. En principe – en supposant encore une fois que les entreprises de taille moyenne choisissent principalement l’Etude de Faisabilité pour gouverner leur contrat dans des transactions transfrontalières – les tribunaux devraient utiliser des bases étroites d’établissement de la preuve quand ils interprètent les contrats. Quoiqu’il en soit, les tribunaux devraient aussi se conformer aux demandes d’une partie d’élargir la base qui leur est applicable.

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1. Introduction

Contractual disputes are often founded in interpretation issues. Interpretation disputes arise either because parties have foregone to specify their rights and duties under the particular circumstances or because they attach a different meaning to an element of their agreement. This is mainly due to the fact that besides the ineptness in the use of words, most contractual transactions do not occur on the spot but over time: ‘contracts regulate the future and interpretive problems are bound to arise simply because the future is inherently unpredictable’.¹

The problem of interpretation provides a central backdrop for the law of contract, which contains many rules and principles designed to address it.² Compared to the economic analysis of contract law in general, however, little attention has been paid to the specific field of the economics of contract interpretation. The way a contract is interpreted relates to the actual law governing parties’ relationship. There are many factors that influence parties’ decision on what to incorporate in their contract and in what form. One of those factors is the criteria proposed by the law to be followed by judges when called upon to resolve issues of contract interpretation. Economic theory can offer suggestions as to what constitutes efficient interpretative criteria.

In this paper, I use an economic approach to analyse the rules on contract interpretation of the Feasibility Study for a Future Instrument in European Contract

In section 2 of this paper, I address the issue of contract interpretation in general and link it to the economic issue of contractual incompleteness. Section 3 critically examines the different types of rules of interpretation and the incentives they create. In section 4, the Feasibility Study’s rules on contract interpretation are scrutinized. This paper ends with a conclusion.

2. Incomplete Contracts and Contract Interpretation

Almost everyone enters into contracts every day. From an economic perspective, a contract refers to any agreement under which two or more parties engage in mutual commitments concerning their behaviour. Within the legal context, a contract can generally be defined as a meeting of minds that creates effects in law.

Parties contract in order to create a bigger transactional pie in a world where parties’ incentives are misaligned. The writing of contracts enables parties to hedge against market risks and to coordinate the production of information, rights, duties, and procedures. Contract lawyers seek to translate an economic deal into a legally enforceable written agreement. This comprises a planning role that involves a range of issues such as the resolution of ambiguities by suggesting express terms that describe in greater detail the deal, the allocation of risks for foreseeable and unforeseeable contingencies, the incorporation of legal and non-legal sanctions, and the introduction of mechanisms of dispute resolution. A contract performs the function of a governance mechanism: it comprises a clear record of the terms agreed upon between parties and the implied promise to adhere to these terms.

2.1 Incomplete Contracts

Regardless of substantial planning efforts, contracts break down because real world contracts are invariably incomplete. In general, a contract is complete when it allocates the rights and obligations of parties efficiently across all possible future contingencies. A contract qualifies as incomplete if at least one of the following elements is not fulfilled: (1) the contract does not specify parties’ rights and obligations for all future contingencies or (2) the contract does not exploit all gains
from trade. The first element signifies that a contract fails to specify the obligations of parties under a certain state of the world that may or may not occur. The contract will contain a 'gap', and courts will have to decide whether they will fill this gap or declare the contract void and unenforceable for matter of vagueness. The second element implies that the contract fails to efficiently allocate obligations across all states of the world. In other words, the terms that have been incorporated are not optimal from an economic point of view. Legal scholars tend to relate the incompleteness of a contract primarily with the first element, while economic scholars relate the incompleteness of a contract with the second element.

The incompleteness of contracts is grounded in several different factors. Economic scholars attribute the incompleteness of contracts primarily to the fact that perfect markets – the concept upon which they base complete contracts – do not exist: markets 'fail'. This failure to create maximum efficiency in the market is ascribed to factors such as bounded rationality, information asymmetries, and transaction costs. Bounded rationality encompasses the thought that foresight is infinitely costly, and, therefore, as the economic literature on contractual interpretation emphasizes, the costs of foreseeing and providing for every possible contingency that may affect the costs of performance to either party over the life of the contract are prohibitive. Even in a setting of perfect foresight, an interpretive problem may arise. This bounded rationality affects contracting parties, as well as third parties. This implies that while some variables might be perfectly well observable by the parties to a contract, these variables are difficult to measure and specify in such a manner that they can be proven to the satisfaction of the court. The variables are non-verifiable.


Therefore, even if parties know which performance they desire and can personally observe whether this performance has occurred, the written contract is incomplete because performance needs to be specified in terms of an easily measurable proxy that can be readily observed by courts. Bounded rationality and information asymmetries raise transaction and enforcement costs. These costs include (1) the costs of gathering and processing information; (2) the costs related with negotiating, specifying, and drafting an agreement; (3) the costs parties incur in order to ensure that each of them adheres to the agreement and fulfills his or her promise; and (4) the costs related to the enforcement of the contract by a third party, for example, a court or arbitrator, including the uncertainty and error costs associated with such an enforcement. 11

Similar factors, such as transaction and enforcement costs and information asymmetries, have been used by legal scholars to explain why most contracts are incomplete. 12 In particular, lawyers attribute the incompleteness specifically to inevitable ambiguities in ordinary language or to the bounded rationality on the part of the contracting parties. These factors thus undermine the ability of parties to construe complete contracts. 13 As Scott states:

\[\text{Parties write incomplete contracts either because (a) the resource costs of writing complete contingent contracts to solve contracting problems would exceed the expected gains or would exceed the costs to the state of creating useful defaults, or (b) the parties are unable to identify and foresee uncertain future conditions or are incapable of characterizing complex adaptations adequately.}\] 14

### 2.2 Incompleteness, Interpretive Issues, and Methods of Interpretation

The issue of contract interpretation relates to the issue of incompleteness. When the contractual incompleteness is such that the contract remains silent on a particular issue, the parties may bring their case before court and the court will use its interpretive skills to attempt to fill the gap. In other situations, the incomplete contract may not be silent but rather unclear. Parties will have said either too little or too much with regard to a particular element of their agreement. In this case, courts will interpret the vague terms. 15 The manner in which courts enforce


13 Other causes of market failure are imperfect competition, externalities, and organizational failures. These factors, however, play a less prominent role in defining incompleteness (cf. VAN BIJNEN, 2005, n. 8, pp. 117-137). For a more extensive discussion of these factors, see, among others, R. COOTER & T. ULEN, Law & Economics, Pearson Addison Wesley, Boston 2003, pp. 217-226.


incomplete contracts is essential to the effort that parties have to make in drafting their contracts. Depending on the manner in which courts interpret agreements, parties will exert more effort in their contract drafting or conversely rely on the court to supplement their agreement in case of an interpretive dispute.

Two general methodologies that courts use to interpret contracts can be distinguished and determine the intentions of contracting parties with respect to their performance obligations: textualism and contextualism.16 Textualism refers to an objective approach to contract interpretation and contextualism, to a subjective approach to contract interpretation. Some authors also employ the term ‘formalism’. Formalism can be projected on a scale where a high degree of formalism corresponds to textualism and a lesser degree of formalism, to contextualism.

Textualism is grounded in the idea of complete contracts, and contextualism is grounded in the idea of incomplete contracts. The theory of complete contracts assumes that parties have incorporated all necessary matters in their written agreement. Textualism relates to this theory as it holds that the words of the agreement govern its interpretation as opposed to inquiries into non-textual sources such as the intention of parties or surrounding context. The contract in writing is presumed to be a complete and precise statement of the terms agreed between parties, and if it is not included in the written document, it is not part of the contract and vice versa; if it is in the written document, it is part of the contract. The whole of the agreement between parties is thus encompassed in the written document. This corresponds to the idea of completeness, which signifies that the contract specifies the legal consequences of every possible state of the world. Completeness implies that the contract on face value should not contain any gaps. When a dispute concerning the interpretation of the terms of the contract does arise, the basis for an interpretive methodology embedded in textualism is to focus on the terms as expressed in the contract. The court will focus on the plain and ordinary meaning of the words as understood by ordinary and reasonable persons.17 Under such an objective approach to contract interpretation, courts must ascertain the intention of the parties from the words as expressed in the written agreement. The amount of information or base of materials that the court can take into account to ascertain what parties have meant in this case is restricted. An example is the ‘four corners’ rule, a basic rule of contract interpretation in American law. The rule bars the parties to a written contract that is ‘clear on its face’ from presenting evidence bearing on interpretation, which is to say, ‘extrinsic’ evidence – evidence outside the ‘four corners’ of the written contract itself. The judge alone determines what the contract means when no extrinsic evidence is presented, the theory being that he/she is a more competent interpreter of a document than a jury is. By placing a

16 The terms ‘contextualism’ and ‘textualism’ originate from the literature on statutory interpretation, where textualism is referred to as a formalist theory of interpretation.
limitation on the influences to the interpretive process, proponents of textualism attempt to minimize the risk of judicial error.

Contextualism, on the other hand, implies that a court will primarily inquire into the actual intention of the parties. The common or actual intention of the parties will prevail above the written contractual document, and norms such as reasonableness and fairness will play a strong role in determining the parties’ agreements. In this case, the base of information or materials that the court can take into account in order to ascertain the actual intention of the parties is potentially unlimited. The court must discern what parties have actually meant, that is, uncover the expectations of parties, by considering not only the written words of the contract but also other contextual evidence, which is used to interpret the scope of the contract. Courts must then be careful to give weight only to outward manifestations of intent and not to the secret intentions of one party. However, the task of determining what the contract is necessarily extends beyond the ‘four corners’ of the written agreement.

Rules on contract interpretation reflect a certain interpretive style by privileging certain materials and discounting others. Based on the above, these rules are termed formalistic when they confine the attention to a subset of materials that may or may not give rise to the same assumptions as would the whole of the materials. A rule that centres on the objective approach is, for example, the rule of parol evidence, which is common under common law. This rule provides that the written document integrates parties’ agreement and the agreement may not be contradicted or varied by other prior oral evidence. On the other hand, the subjective approach relates much more to the materials as a whole and an understanding based on the materials reasonably available.

3. Economic Consideration and Interpretive Strategies

The goal of a doctrine of contractual interpretation is usually to minimize transaction costs. Because methods of reducing transaction costs are themselves costly, a trade-off must be made between the benefits associated with the reduction of transaction costs and the costs of the methods applied to effectuate the reduction. From an economic perspective, the objective and subjective approaches to contract interpretation can be linked to the issue of optimal information gathering. The choice between the objective (textual) and subjective approaches (contextual) to contract interpretation regulates the information transmission between parties and between the parties and the court. The interpretation of a contract is an ex post exercise, which implies that the court can only attempt to (partially) verify events that have taken place ex ante. Parties thus can often observe events that cannot be verified by the court. Events may be partially verifiable in the sense that a third party such as a court cannot observe these events with the similar precision as the parties to the contract. More in particular, doctrines relating to interpretation can be associated with the relationship between contracting parties, the third-party
enforcer, and the extent to which the burden of information acquisition is allocated between these two parties. A court’s interpretation of the contract is thus dependent upon the information available to it. This information set draws from three potential sources: the information embedded by the parties in the contract itself, the information presented by the parties to the court \(ex post\), and the information available to the court based on its general knowledge and experience. Information communicated to the court by the parties is either based on a cooperative strategy in an attempt to maximize the returns from contracting or litigation or on a non-cooperative strategy where each party individually decides what information to introduce. The introduction of information by the parties themselves is costly.

Posner states that regarding the available information, a trade-off takes place between Type I errors and Type II errors.\(^\text{18}\) A Type I error means that the court will enforce a term that is not part of a contract. A Type II error, on the other hand, means that the third-party adjudicator fails to enforce terms that are part of the contract. In particular, the interpretive regime of contracts consists of a function that specifies how the agent bestowed with the interpretive role, such as the court, understands possible sources of information. A fuller and broader context, in the sense of a broader base of materials, as under the subjective approach, can always be purchased. This will, however, happen at cost of time, trouble, and the inference of incentives.\(^\text{19}\) The introduction of information to the court is costly because it raises transaction costs for parties. However, the costs of \(ex post\) and \(ex ante\) information gathering interact, and more information can also help the court reach a more efficient decision from an economic perspective. In well-developed markets, courts should generally allow the contextual evidence to supplement express terms but should generally not allow contextual evidence to override the plain meaning of the express terms.\(^\text{20}\) As previously mentioned, an objective approach or more formalist approach to contract interpretation would be one that limits the influence of certain types of information in contrast to a subjective or less formal approach where all information available is considered.\(^\text{21}\)

Given all these considerations, it is difficult to draw conclusions on which interpretive strategy should be preferred. When the assumptions on the costs and benefits of information acquisition are restricted, more specific conclusions may be drawn. Schwartz and Scott, for example, develop a model in which parties benefit when contract terms are interpreted correctly on average\(^\text{22}\) and are quite risk-neutral to interpretive variance around the mean. In such a case, it would be optimal for the court to make decisions on a minimum evidentiary basis while

\(^{18}\) See POSNER, 2005, n. 1.

\(^{19}\) HERMALIN, KATZ & CRASWELL, 2007, n. 2.


\(^{21}\) HERMALIN, KATZ & CRASWELL, 2007, n. 2.

\(^{22}\) SCHWARTZ & SCOTT, 2003, n. 6.
additional interpretative efforts are costly. Other authors, on the other hand, assume that ex ante contract writing is costly and it is possible for parties to write at least some interpretive rules that may be applied without costs. In this case, it is thus optimal for parties to leave at least some interpretive issues concerning contract terms to the courts. If contract-writing costs are sufficiently high, courts may override these terms in favour of another interpretation.

Legal systems and harmonization instruments reflect different approaches that can be adopted and that enable the introduction of objective elements in the interpretative process. The manner in which issues of interpretation are addressed and the types of legal rules that play a role in interpretative strategies are largely dependent upon the legal system in which the dispute is brought before court. Common law jurisdictions generally take a more objective approach toward the interpretation of contracts. Civil law systems, on the other hand, adhere to a rather subjective theory of contract interpretation. Civil law systems usually do not place limits on the kind of admissible evidence. In addition, dependent on the jurisdiction, courts may be more or less lenient to supply a term to remedy a contractual gap.

3.1 Types of Interpretive Strategies
Apart from the two aforementioned main interpretive strategies, the textual or objective approach and contextual or subjective approach to contract interpretation, a range of different interpretive strategies exists that can be used to fill gaps or interpret vague terms. Economic analysis can help to identify the conditions under which various interpretive strategies approximate parties’ intentions and make courts and parties better off. Economists have proposed a number of interpretive strategies for courts. Some of the main strategies are discussed here. The regime of contract interpretation influences contracting parties’ behaviour in many respects. This concerns decisions to breach, advance precautions, mitigation of damages, the gathering of information, allocation of risks, etc. The doctrines concerning default rules, for example, relate to the relationship between the parties and third-party enforcer, but they are also concerned with the contracting parties’ informational relationship with each other.

3.1.1 Majoritarian Default Rule
The idea of a complete contract is closely related to the notion of default rules. These are rules that are used to fill a gap in a contract if parties have foregone to specify their actions under a particular contingency. The function of default rules is to provide guidance to third-party enforcers in interpreting contract terms on which parties do not otherwise (clearly) agree. A judge may choose to fill a gap in the contract with a default rule. Scholars in the field of law and economics literature

23 GOETZ & SCOTT, 1985, n. 20, pp. 261 et seq.
have taken different approaches to the manner in which default rules should be set. One of these approaches has been introduced by Goetz and Scott, who argue that the default rules should be set in such a manner that these minimize the cumulative transaction costs incurred by parties contracting around them.\(^{25}\) In the case where all parties face similar transaction costs and it is equally costly to contract around the terms, this implies terms that would be favoured by a majority.

In case of a majoritarian default, parties know that courts will apply a term that maximizes the probability of efficient trade. Accordingly, they would be more willing to enter a contract in the first place, despite high transaction costs, than they would under an alternative rule. In choosing a majoritarian default rule, the negative consequences of high transaction costs are reduced. In a system of a majoritarian default, the courts minimize transaction costs by choosing a mix of express and implied terms that most contracting parties would prefer. The majority of parties might want the court to use implied terms because this saves contracting costs. Alternatively, a majority might believe that relying solely on express terms may be less reliable than relying on well-established implied terms. An example of a majoritarian default rule is that contracting parties in a certain trade are bound by trade usages even when they are not familiar with them. Such a majoritarian default encourages parties in the particular area of trade to develop such usages and familiarize themselves quickly with them. The implied majoritarian default reduces the need for prolix documents. The majoritarian default rule acts like a public good in that it creates a standard set of terms. When an interpretation dispute arises, the majoritarian rule can be applied to the interpretation of express terms. In this sense, a plain meaning rule may also create an incentive for parties to learn the common meaning of words. This reduces the need for and costs of elaborate definition and explanation.\(^{26}\)

The disadvantage of the majoritarian default theory is that empirics are necessary in order to define majoritarian rules. It is essential for the legislator and judges to uncover which rules are favoured by the majority of parties. This is difficult to achieve. In addition, it is necessary to determine when parties will contract around the majoritarian default. Goetz and Scott argue that default rules should be chosen to provide terms that would minimize cumulative transaction costs incurred by parties contracting around them.\(^{27}\) In the special case where all parties face similar contracting costs and it is equally costly to contract around all terms, terms would be favoured by the majority. If some terms, on the other hand, are costlier to contract out of or into than others, it is harder for parties to specify multifactor standards than simple rules. In this case, \textit{ceteris paribus}, the default should be set to terms that are easiest for parties to escape.\(^{28}\) This is a transaction

\(^{25}\) GOETZ & SCOTT, 1985, n. 20.
\(^{27}\) C. GOETZ & R. SCOTT, 1985, n. 20.
\(^{28}\) SCHWARTZ & SCOTT, 2003, n. 6.
costs reducing approach to default rules. Moreover, Posner states that the responsibility for choosing default rules puts an unrealistically high informational burden on the courts. However, although it is true that literalism places a lighter burden on courts, it does not mean that literalism is superior to the majoritarian approach. The choice between the two approaches is an empirical question about which I have no evidence. Schwartz stresses the complexity of the choices that the majoritarian approach requires courts to make, but he discounts the benefits to parties, who save on transaction costs to the extent that courts succeed, and can design their contracts to minimize risk to the extent that courts fail.

3.1.2 Hypothetical Standard

Posner states that the goal of contract interpretation and the manner in which courts should interpret contracts is to save transaction costs. Therefore, the incentive should be to save transaction costs by completing a vague norm in the manner that parties would have agreed upon if they would have taken the effort to write a complete contract. Of course, it is difficult to discern which terms parties would have used. In this case, it is important to ascertain the actual intention of the parties, and the courts will use a broad base of materials in order to do so.

This approach seems to relate very much to the subjective approach to contract interpretation. In order to distil the actual intention of the contracting parties, the court will indeed need to take into account the whole of the background materials or context in which the transaction is set. Only in this manner will the court be able to come within reach of the actual intention of parties ex ante. Account should be taken of the fact that in this case, a Type I error (see above) is more likely to arise, that is, the court will risk enforcing a term that is not part of the contract.

Benson argues in this respect that it is highly unlikely that anyone can know what rule parties to an actual contract with individual differences in bargaining power, information, risk aversion would have agreed to ex ante. In addition, legislators and judges, depending on their background and specialized knowledge, will have different views on what parties would have agreed to if they had addressed the issue. Benson instead argues that default rules are in fact established by collective action and that it is very difficult to discover what percent of relevant contracting parties would have proposed the particular default rule if they had considered the issue.

3.1.3 Penalty Default

Strategic interpretation has as goal to reduce irrationality and information asymmetry. The strategy is to choose a ‘penalty default’: a meaning of a word that most parties to a

29 SCHWARTZ, 1998, n. 5.
30 SCHWARTZ, 1998, n. 5.
31 POSNER, 2003, n. 9.
particular contract would not use. This strategy, which would give parties an incentive to write a less ambiguous contract than they might otherwise, has two motivations. First, it discourages parties from externalizing the cost of interpreting the contract by way of the courts. If parties are clearer, courts will have less work to do. Second, it discourages parties from opportunistically concealing information from each other. If one party knows about the ambiguity of a particular word and prefers the majoritarian meaning and the other party does not know about the ambiguity, then the first party would have no incentive to disclose the ambiguity to the second, unless a penalty default rule held the informed party to the less favourable meaning. Ayres and Gertner state that textualism may be considered as a type of penalty default rule in the sense that it prevents strategic obfuscation by limiting judicial inquiries to the face of the text.34

The third-party enforcer should not seek to consult contextual elements. Another example offered by Ayres and Gertner is the doctrine of contra proferentem, the doctrine under which ambiguous terms are interpreted against the interest of the drafting party. This rule serves as an incentive for the drafter to choose clear language and will disclose to the other party the meaning of the relevant terms. Penalty defaults thus are terms that operate as a penalty for non-disclosure. This can also be considered a type of information-forcing approach.

3.1.4 Efficiency

Another strategy is for the court to enforce whatever term would be efficient in the particular case. One can derive this term by asking the question, ‘Supposing that transaction costs had been zero at the time of contracting, what would the parties have done?’ Buyer and seller would have anticipated their dispute about the meaning of a vague term and either chosen a more precise term (if trade is still efficient) or not made a deal (if trade is not still efficient). What they would have done depends on the costs and values of the trade. The difference between this strategy and the majoritarian default is the difference between a standard and a rule. The court chooses whatever is efficient for the contract in dispute rather than enforcing whatever term is efficient for the majority of parties who enter similar or identical contracts. This approach thus advocates choosing default rules for their substantive efficiency. This approach is especially appealing in settings with network externalities, adverse selection, and bounded rationality in the contracting environment. Under these conditions, parties are then reluctant to depart from familiar and widely used terms. Korobkin, for example, illustrates that cognitive and social-psychological factors induce parties to stick to default contract terms that they would actually be better off contracting around.35 Kahan and Klausner have argued that the network externalities that we find in the corporate and business environment regarding contracting practices are due to the regular use of

34 AYRES & GERTNER, 1992, n. 5.
standardized forms.\textsuperscript{36} The value of these forms depends on the population of the users that have invested their expertise in the production of these forms.

Which rules are considered efficiency-enforcing default rules depends very much on the context. This perspective supposes that the third-party enforcer can choose from a wide range of available defaults and imply whichever term is efficient in a particular situation. Kahan and Klausner argue that efficiency effects may be created by the regular use of standardized forms. Another element that plays a role here is that this perspective assumes that the court is able to enforce efficient terms. However, the court is also affected by bounded rationality, information asymmetries, and cognitive biases, which may lead to interpretive errors. In addition, the court would need to acquire both \textit{ex ante} and \textit{ex post} information on the contractual setting in order to determine the most efficient outcome or term at the time of the dispute and taking into account the turn of events that have lead to the dispute in the first place. In short, high expectations are placed upon the third-party enforcer under a strategy of efficiency.

4. Application to the Feasibility Study’s Rules on Interpretation

Article 56(1) of the Feasibility Study reveals that the ‘contract is to be interpreted according to the common intention of the parties even if this differs from the literal meaning of the expressions used in it’. This encompasses a subjective (or contextual) approach to contract interpretation. Paragraph (1) seems to follow the approach of the civil law systems, where the common intention prevails over the plain meaning of words or the text within the four corners of the document. However, Article 56(3) of the Feasibility Study adopts a more objective approach: the contract is to be interpreted according to the meaning that a reasonable person would give to it if an intention cannot be established under Article 56(1) and (2). Article 58 also adopts a more objective approach: ‘Expressions used in a contract are to be interpreted in the light of the contract as a whole’. The rules mentioned in the Feasibility Study generally appear as reproductions of the rules contained in the Draft Common Frame of Reference\textsuperscript{37} and the Principles of European Contract Law.\textsuperscript{38}

The traditional view in relation to contract interpretation is that but for the cost, contracting parties would write complete contracts. Contract law – and this is also true for instruments such as the Feasibility Study – may increase efficiency in cases where contracting costs prevent parties from solving contracting problems. The justification for defaults is thus that it does for contracting parties what they

would have done for themselves had their contracting costs been lower. According to Schwartz and Scott, there are three criteria for a good default: the default must be (1) conditioned on only a few possible states of the world, (2) relatively simple in form, and (3) efficient for a wide variety of contract parties. The third criterion is possibly most difficult to satisfy. Usually, parties in large economies are heterogeneous, and default rules would be too expensive to create if efficient solutions were party-specific.

However, parties that choose the Feasibility Study to govern their contractual relationship are unlikely to qualify as being heterogeneous. It seems to me that, if at all, medium-sized firms in international transactions will choose the Feasibility Study to govern their contract. Large companies will not make use of an optional instrument such as the Feasibility Study. In the case of international transactions, they will be able to (or at least they will try to) ‘dictate’ the terms and conditions of the contract and/or make a choice for one of the existing national contract laws. In addition, large firms are able to operate nationally through their subsidiaries, which implies that strictly speaking, they often do not even contract across borders. Small firms do not typically trade across borders. Also, consumers will likely not make use of the model rules in the Feasibility Study. Consumers tend to shop mostly locally (i.e., close to their place of residence), independently of whether they have to cross a border or not. Thus, it will be medium-sized firms that may make use of the Feasibility Study in the future. This is a major difference with the existing national contract laws (these contract laws need to contain default rules for a multitude of contract parties).

Against that background, I do not believe that the subjective approach of Article 56(1) should have been chosen as the default approach. I agree with Schwartz and Scott that firms probably typically prefer courts to adhere as closely as is possible to the ordinary meanings of the words that the parties used, that is, in my opinion, firms typically prefer the textualist approach. At the same time, the textualist theory will not suit all parties all of the time. Therefore, parties should have the possibility to contract around the textualist default. It should be noted, however, that ultimately, the preference of firms between the objective and subjective approaches is an empirical question on which I have no real evidence.

Article 56(2) of the Feasibility Study incorporates a penalty default rule:

If one party intended an expression used in the contract to have a particular meaning, and at the time of the conclusion of the contract the other party was

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aware, or could be expected to have been aware, of this intention, the expression is to be interpreted in the way intended by the first party.

Article 63 of the Feasibility Study may also be characterized as a penalty default rule:

Where...there is doubt about the meaning of a term which has not been individually negotiated, an interpretation of the term against the party who supplied it is to be preferred.

Article 57 establishes a matrix of relevant matters that may be taken into account when interpreting the contract, including the circumstances in which the contract was concluded (e.g., preliminary negotiations), the conduct of the parties, the interpretation that has already been given by the parties to terms or expressions, the meaning commonly given to terms or expressions in the branch of activity concerned, the nature and purpose of the contract, usages, and good faith and fair dealing.

Good faith and fair dealing impose moral standards of conduct on parties, which may override the explicit terms of the contract if these do not satisfy requirements of decency, fairness, or reasonableness. Any attempt to provide a single, unifying definition of good faith and fair dealing becomes reductive. This is especially true for an instrument such as the Feasibility Study, as definitions of decency, fairness, or reasonableness will be even more difficult to formulate in a multinational context. Parties’ conduct must thus be evaluated on a case-by-case basis by courts, which may result in judicial errors. Especially in the context of the Feasibility Study, judicial errors seem likely since - assuming parties chose to have their contract governed by the Feasibility Study – national courts of, for example, EU Member States would have to evaluate decency in, presumably, international contexts.

In law and economics, a good faith and fair dealing obligation is considered an implied contractual term that prohibits opportunistic behaviour. Opportunistic behaviour occurs when a party behaves contrary to the other party’s understanding of the contract, but not necessarily contrary to the agreement’s explicit terms, leading to a transfer of wealth from the other party to the opportunistic party. I believe good faith and fair dealing should be a rule that parties are free to contract around. This is not explicitly mentioned in the Feasibility Study, and parties that would choose to apply the Feasibility Study to their contract thus explicitly have to state this in their contract, which raises transaction costs.

Critics of the doctrine of good faith and fair dealing in contract law have argued that the doctrine creates too much uncertainty. However, it is not certain that this argument holds for relational contracts in general or for international contracts in particular. In long-term agreements, any uncertainty that results from the judicial construction of the good faith or fair dealing requirement may be
overshadowed by the uncertain risks of entering into the relationship in the first place. In theory, parties can contract around any contingency, but their inability to predict the future places inherent limits on their ability to manage risks through contracting. The longer and more intense the relationship is, the more difficult it is for parties to foresee potential problems. The chance that one party will act in bad faith raises the cost of entering into the contract in the first place, potentially rendering the cost of negotiations prohibitive. Therefore, the doctrine of good faith and fair dealing can act as insurance against these risks and reduce transaction costs.

In relation to the other ‘relevant matters’ of Article 57 of the Feasibility Study, I am of the opinion that courts, in principle, should use narrow evidentiary bases when interpreting agreements. Again, I assume that the Feasibility Study will primarily be used by medium-sized firms in international transactions. On the other hand, courts should also comply with party requests to broaden the base that is applicable to them. This implication differs from Article 57.

Article 61 of the Feasibility Study states that ‘An interpretation which renders the terms of the contract effective is to be preferred to one which would not’. I am of the opinion that this rule is generally useful and corresponds with the preferences of most contracting parties. I do note, however, that these rules may lead parties to invest less resources in contract drafting.

Finally, I believe Articles 60 (‘Terms which have been individually negotiated prevail over those which have not’) and 59 (‘Where a contract document is in two or more language versions none of which is stated to be authoritative and where there is a discrepancy between the versions, there is a preference for interpretation according to the version in which the contract was originally drawn up’) contain rules that parties generally prefer. These rules are likely to lower transactions costs.

5. Conclusion

In this paper, I have used an economic approach to analyse the rules on contract interpretation of the Feasibility Study. My main findings are twofold.

First, I do not think the subjective approach of 56(1) should have been chosen as the default approach. I assume that primarily medium-sized firms in international transactions will choose the Feasibility Study to govern their contract. As explained, firms, in my opinion, typically prefer courts to adhere as closely as possible to the ordinary meaning of the words in the agreement. That is to say, firms typically prefer the textualist approach. The textualist theory will not always suit contracting parties. Contracting parties should have the possibility to contract around the textualist default.

Second, I am critical of Article 57 of the Feasibility Study. In principle – assuming again that primarily medium-sized firms in international transactions will choose the Feasibility Study to govern their contract - courts should use narrow evidentiary bases when interpreting contracts. Nevertheless, courts should also
comply with party requests to broaden the base that is applicable to them. This approach is different from that of the Feasibility Study.

Summary
In this paper, I use an economic approach to analyse the rules on contract interpretation of the Feasibility Study. The main findings of this paper are twofold. First, assuming that primarily (medium-sized) firms in international transactions will choose the Feasibility Study to govern their contract, the subjective (or contextual) approach of Article 56 of the Feasibility Study should not have been chosen as the default approach. Firms typically prefer courts to adhere as closely as possible to the ordinary meaning of the words in the agreement. That is to say, firms typically prefer the textualist (or objective) approach. The textualist theory will not always suit contracting parties. Therefore, parties should have the possibility to contract around the textualist default. Second, Article 57 of the Feasibility Study is less advantageous for contracting parties. In principle – assuming again that primarily (medium-sized) firms in international transactions will choose the Feasibility Study to govern their contract – courts should use narrow evidentiary bases when interpreting contracts. However, courts should also comply with party requests to broaden the base that is applicable to them.
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