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Abstract: This article, following Richard Posner's 'The Law and Economics of Contract Interpretation' paper, aims to explain how vital and complex the issue of legal interpretation is. An economically optimal interpretation leads to efficient allocation of resources, the main goal of economic research. In order to reach economic effectiveness, contract interpretation ought to be focused on exactly determining its terms. Therefore, the parties are provided with clear instructions on how to perform as well as with a remedy for breach. Transaction costs will be then minimized. Contract transactions costs' structure presented in the article is composed of negotiation costs, probability of litigation and litigation costs while the latter is influenced by interpretation's efficiency level. There are different ways to reach this efficiency and avoid error costs caused by misinterpretation. The article mentions solutions such as gap filling, form contracts, disambiguating, 'good faith principle' and some particular tips. It contains also an analysis of the Common Law systems that lean toward literal interpretation and the Civil Law systems that tend to extend the wording of a contract with the 'good faith principle', 'fair dealings principle' and so on. The article concludes that methods of interpretation are a part of legal and economic reality in any given system and should therefore be analyzed as an entity as regards their efficiency.

Streszczenie: Ten artykuł, oparty na tekście Richarda Posnera „The Law and Economics of Contract Interpretation", jest próbą wyjaśnienia jak ważna i złożona jest kwestia interpretacji prawa. Interpretacja optymalna ekonomicznie prowadzi do efektywnej alokacji zasobów, głównego celu poszukiwań ekonomii. Aby osiągnąć swój cel ekonomiczny, interpretacja umowy powinna przede wszystkim polegać na dokładnym określeniu jej warunków. W ten sposób, strony umowy otrzymają jasne instrukcje jak ją wykonywać oraz rozwiązania na wypadek jej niedotrzymania. Zminimalizowane zostaną również koszty transakcyjne. Struktura kosztów transakcyjnych, przedstawiona w artykule, składa się z kosztów negocjacji, prawdopodobieństwa postępowania sądowego oraz kosztów postępowania sądowego, na które to koszty wpływa poziom skuteczności interpretacji. Ta skuteczność oraz eliminacja kosztów błędów spowodowanych niewłaściwą interpretacją może być osiągnięta różnymi sposobami. W artykule wymienione są takie rozwiązania jak: uzupełnianie luk, gotowe umowy, wyjaśnianie wątpliwości, zasada „dobrej wiary" oraz pewne rozwiązania partykularne. Zawiera on również analizę systemu prawa zwyczajowego, który faworyzuje interpretację literalną oraz systemu prawa cywilnego, który uzupełnia dosłowne brzmienie umowy poprzez zasadę „dobrej wiary", „dobrych praktyk" itd. Artykuł stwierdza, że metody interpretacji prawnej są częścią prawnego i ekonomicznego porządku w danym systemie, który powinien być w całości poddany analizie pod względem skuteczności ekonomicznej.

Keywords: contract, transaction costs, interpretation

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I. Introduction

This essay aims to present the main issues concerning contract interpretation, everything that may influence it and the effects it causes. For proper understanding of the term we should distinguish contract interpretation from formation, validity, remedies and other issues of law and economics. Interpretation may be seen as a subject of study not only for cognitive psychology, epistemology, legal doctrines, linguistics[1] and literary critics but also for economics. The main point in interpretation by a judge, jury or arbitrator is to find out what the terms of the contract are and how they should be understood[2]. The function of interpretation of contract law is to provide instruction for parties on how to perform and the remedy for breach in order to enhance the utility of contracting as a method of organizing economic activity. Doubts concerning meanings of the terms arise through time. The reason why it happens can be found in the nature of contracts and their function. Contracts rarely concern simultaneous activity of the parties or goods of constant quality. As performance will take place in the future and the quality is not constant, the contract should assure an equal position of the parties under changing conditions. However, the contract does not have to be perfect. A perfect contract foreseeing all possible sorts of future situations would be infinitely costly, thus impossible.[3] The aim of a system, methodology, doctrine and other tools of interpretation of a contract is to minimize transaction costs so that resources can be allocated efficiently.

II. Gap Filling, Disambiguating and the Good Faith Principle

Posner presents a mathematical equation reflecting broadly defined transaction costs.

$$C= x + p(x)[y +z +e(x, y, z)]$$

where C- total transaction costs, x- negotiation and drafting costs, p- the probability of litigation, y- the parties' litigation costs, z- the costs of litigation to the judiciary, e- error costs (misinterpretation of a contract, gaps, unclear terms)

The first term (x) refers to negotiation costs including the determination of meanings of terms of a contract and decision about the content of the contract. The second term ($p(x)[y +z +e(x, y, z)]$) represents the second stage where, in case of a legal dispute over the

[1] Check: United Nations Charter, as a document with six language versions, which are equally valid, happens to become an object of profound philological analysis.
[2] Farnsworth (2004), Ch. 7.
[3] See, for example, Tirole (1999) p. *772.*

meaning, the matter is submitted to adjudication. It sums up the cost of litigation, the costs of means parties would spend on litigation, the costs of the court's performance and the costs of errors of the parties and of the court (e.g. misinterpretation of a contract).

All the costs mentioned in the second term can be discounted by a lower probability (p) of a legal dispute. The probability of litigation is lower if the parties invest in negotiating and creating a clear contract before. The effect of direct, clear collection of rules can be reached thanks to a formalistic, strict interpretation of a contract. The reason why we should not choose this way of interpretation seems to be obvious: the parties forced to negotiate the perfect contract can spend more money than they would pay for litigation, therefore the rise of 'x' may exceed the profits of lowering 'p'. Therefore the object of the legal enforcement of contracts is to minimize the sum of costs included in second term rather than to insist the parties do everything to negotiate a perfect contract.

Parties of a contract tend to reduce transaction costs. There are many aspects that determine transaction costs and so there are many solutions to avoid or reduce them. As the near future is more predictable than the distant future, parties may want to shorten the duration of the contract in order to reduce the error costs arising in time. Sometimes parties choose not to include anything about the interpretation of the contract in future conditions. They want to save up on negotiation costs when a given situation is unlikely to happen in the future. They can also leave the contingency not provided for if they know that a situation is likely to happen but they cannot agree on some points. It is a form of compromise called 'agreeing to disagree'. The predictions of the parties about possibility and level of the costs determine their decision whether to stay longer at the negotiation table or not. They can also negotiate some issues and agree to negotiate the other ones in the future, so called 'agreeing to agree'. The solution is vertical integration for contracting. Economic calculation or intuition, along with a will to avoid being dependent on the other party are incentives for a producer to make something himself rather than buy it, and so he/she can replace the contract to purchase a good with contract of employment.

The main alternative for these actions is to have a court or an arbitrator to fill in the gaps in the contract when a legal dispute is likely to emerge. Courts are helpful with interpreting clauses like 'force majeure clause' or 'best efforts clause' if the parties have not defined these clauses in contract. Referring to form contracts in relations of consumers with firms, associations or professional associations we may observe that these form contracts can be less advantageous to the consumer because they are generally constructed by the other

party. This disadvantage of a form contract differs it from gap filling made by the court or the arbitrator although the purpose of both is to eliminate the conflicts that may arise through the performance. As Posner sums up: 'Standard clauses that evolve in litigation or arbitration created or approved by an impartial third party, are more likely to be neutral'[4].

However, form contracts or clauses allowed to be included in a contract can be given by the Code of Laws.[5] In continental Europe parties can get to know quite easily what their performance should look like. Codes of law, courts' sentences, and the doctrine with their rather stable character are the bases of the system.[6] To illustrate the difference between a Common Law contract and a Civil Law contract let me refer to art. 242 of the German Civil Code that says that the obligor must perform his duty in accordance with good faith and fair dealing having regard to commercial practices. This provision has been used to provide a "moralization" of contractual relationships and it has been applied to change the rigorous individualism of the original contract law of the Civil Code. The German system has developed new institutions and thereby created a number of obligations which ensure a loyal performance of the contract, such as a duty to co-operate, to safeguard the other party's interest, to give information and to submit accounts. They have held that a party's right may be limited or lost if enforcing it would amount to an abuse of rights. The good faith principle is open-ended and may admit new institutions.

Dutch Law goes even further. Art. 6:2 of the Civil Code provides that good faith shall not only supplement the parties' obligations, but may also modify and extinguish them. The other interesting law rule is art. 56 of the Polish Civil Code which says that a party's legal act causes the effects not only literally expressed in itself but also those attached to a particular sort of legal act by the law, the rules of social coexistence and certain customs.

In contrast, the common law of England does not recognize any general obligation to conform to good faith and fair dealing. The common law courts have been reluctant to open the floodgates of legal uncertainty that this principle would entail. The English common law does not control the substance of contract clauses. It does not impose a general requirement that contracts may not be unconscionable or that contract rights must be exercised reasonably.[7]

[4] Posner (2004).
[5] Hill and King (2004) p. 912-915.
[6] Lando (1999), p. 3.
[7] Lando (1999), p.4.

English law managed to reach the similar results as those worked out by good faith principle in continental Europe by specific rules. The courts have limited the right of a party who is the victim of a slight breach of contract to terminate the contract on that ground when the real motive was to escape a bad bargain. The victim of a wrongful repudiation by the other party is not permitted to ignore the repudiation, complete his own performance, and claim the contract price from the other party when the victim has no legitimate interest in doing so. A common law court has held that an architect could not exercise a power conferred upon him in a construction contract to order work to be omitted, simply to give the same work to another contractor who was prepared to do it for less.

However, good faith cannot in general prevail over clear contrary provisions in the agreement even though they lead to unfair results and the court can deny explaining meanings of some contract terms. In specified conditions it may be too costly to decide what is a "reasonable price" or "reasonable amount". As parties want to maximize their profit, first of all they want to achieve the excess of benefits over costs and then they expect the excess to be shared in a way to be satisfied with. Every party knows best what the convenient share of the excess is for them. The court is not able to have such a sensibility so it is usually better to determine meanings of contract terms by the parties.

Parties are able to choose between legal rules giving a definition of a term or a standard giving a 'custom designed contract'. A rule is clear by virtue of being exact, but it is not the best solution in unforeseen situations. A standard is flexible, although the price of flexibility is vagueness. A help of gap filler is significant. Courts interpolate some details into contracts and contract interpretation. This leads to a reduction of transaction costs and replacing them with judicial costs. In the code law systems it is easier to use a standard clause that has been approved by courts and practice.

Giving 'a market view' on contracts one may say 'bad' contracts can be excluded by the free market competition – the other sellers can outcompete the 'bad' contracts by 'good' contracts; consumers obviously prefer the latter. Unfortunately the profit of consumer satisfaction is not enough to make a 'good' contract a point of making business. Moreover, a 'good' contract could include a very clear litigation clause (consumer receives simple information - if you do not like something you can always sue us) that spoils the reputation and make the litigation more likely. The next point is that asymmetry between seller and buyer is well visible. A seller is aware of importance of reputation and the threat of being sued whereas a consumer does not have such worries. From this point of view a 'bad' contract

is a means to reach equilibrium between the parties. (A thesis that bad quality goods play an important role in economics has been confirmed by the Akerlof's model of Lemons principle saying that in markets with asymmetric information, the bad quality goods (lemons) tend to drive out the good quality ones, which may as a consequence lead to market extinction.)

III. Methods of disambiguating contracts

Misunderstandings between the parties may concern poorly described conditions of contract such as: various deadlines in different parts of contract or imprecisely indicated object. To deal with problems like this the court might proceed in a couple of ways. Firstly, it may assume that the misunderstanding is a result of some technical or linguistic mistake and try to determine the real intentions of the parties. Also, the court may go for the most economically efficient solution, assuming that this is what parties would want. Other solution would be to solve the ambiguities against the party which tried to profit from unclear contract - the one which drafted it or the one which tried to enforce it. Lastly, the court may stick to the text of contract assuming that it is a complete agreement between parties and nothing else should be taken into account. This is the method of the literalist or formalist interpretation. The solutions vary in terms of costs and benefits. The first way confers the greatest benefits just because the parties know exactly what is best for them. However, the court's inquiry on parties' plans may be very costly. Looking for the most economically efficient interpretation is less costly, but the court is never able to know what is the best solution as well as the parties can. The third approach is the cheapest one but also yields fewest benefits in most cases. And also transactions costs arise. Parties will spend more on drafting a contract to avoid an arbitral decision. In situations when none of the parties is blamable or both of them are blamable for uncertainties in the contract it would efficient to rescind it. If a judge does not know the 'real world' conditions well, he or she would stand in favor of the literal interpretation. The effects of it are dependent on the size and the character of uncertainty.

Referring to the first of the mentioned solutions, determining parties' intentions, we should consider the cheapest possible way of doing it. One of them is to pick a competent, professional and honest interpreter. To illustrate the possible effects of such a choice let us assume that a judiciary is just perfect. Errors and uncertainty costs would be minimized and litigation costs would lower. Parties would be also less likely to cheat on interpretation because a perfect judge would catch all the attempts of doing so. On the other hand, the government expenditures on salaries for judiciaries and on courts would be very high.

Furthermore, the parties would become less careful in drafting a contract and more likely to litigate. To sum up – a perfectly designed judicial interpretation may lead to inefficient contracting. At the other extreme let us imagine an extremely poorly organized law system. In these conditions it would be best to attach the responsibility and the consequences of uncertainties to one party or to interpret a contract in a formalistic way. This would not probably bring the most efficient result but determining the intentions of the parties or looking for the efficient solution by an incompetent judge would be a true disaster. In this case parties have an incentive to draft an exact, shorter contract or to include an arbitration clause to avoid litigation.

Arbitration can be found attractive for many reasons. In comparison to a trial it is discreet and the effects are usually not publicly known. The arbitrators tend to act on the basis of commercial custom rather than on formal law and moreover they often go for the 'middle of the road' decisions that are acceptable for both parties. They also know business language better. The popularity of arbitration may be explained by the fact that arbitrators are not constrained by legal rules like the judges are, their judgments are not subject to appellate review, they are able to base their decision on commercial experience and so they do this. However, for the same reasons, their judgments are less predictable. There is a solution to combine qualities of arbitration with legal character - find a judge, or broadly speaking, a lawyer with commercial knowledge.

Referring to the quality of the law service differences between Common Law and Civil Law systems may be observed. In the former judges are definitely closer to the real world thanks to their earlier practice. The advantage of the continental system is that parties are less likely to input unclear terms in contracts just because all the contracts are more or less similar and judges will take into account earlier judgments in similar cases, the Supreme Court's judgments and the doctrine.

IV. Particular interpretation tips

Posner presents a very interesting case referring to 'future situation' clause. 'Alcoa signed a contract with Essex in 1967 to convert Essex's alumina into aluminum. Because the contract had a long term (21 years, at Essex's option), the parties included a price index escalator clause based in part on the wholesale price index for industrial commodities. Energy is a small component of the index but the major input into the manufacture of aluminum. As a result of the steep increase in the price of oil and therefore of electricity (…) in 1973 and

1974, Alcoa's cost of contractual performance rose much faster than the WPI, precipitating its suit for reformation. The court ruled in Alcoa's favor, holding that the parties had intended the price escalator clause to reflect the real increase in Alcoa's costs over the life of contract.'[8] Here the transaction costs of establishing a perfect price escalator were moved from the parties to the court. The court completed a contract in a way. On the other hand if the parties wanted to prevent their contract from the court's interpretation on basis of the negotiation process and their intentions they might include a clause saying that a contract is complete and any pre-contractual facts should not be taken into consideration by the court.

Broadly speaking, contracts should indicate the party which is able to bear the risk at lower cost. This rule may also determine a court's decision, as it was said in the paper, courts try to make the 'best guess' on interpretation and therefore limit the formal interpretation. Moreover, the latter is not only constrained by judge's will but also meets obstacles that have been expressed in judgments in the United States. 'An interpretation which sacrifices a major interest of one of the parties while furthering only a marginal interest of the other should be rejected in favor of an interpretation which sacrifices marginal interests of both parties in order to project their major concerns' [9]. 'A contract will not be interpreted literally if doing so would produce absurd results, in the sense of results that the parties, presumed to be rational persons pursuing rational ends, are very unlikely to have agreed to seek.'[10]

Let us go now to the *contra proferentem* rule which says that in cases of doubt an ambiguity in contract should be resolved against the drafter of the contract. It comes from the assumption that a drafting party was probably in better position to avoid ambiguities. Posner stands if favor of the application of this method only in the cases of insurance companies because they are better risk bearers.

Interpretation methods in continental Europe are of course very different. In the Common Law systems fairness and reasonableness may play a part in doubtful cases, but they cannot be used against a clause in the agreement which was clearly intended. In Europe contracts are to be interpreted in accordance with good faith and fair dealing having regard to commercial practices, see the German Civil Code § 157 or the Polish Civil Code Art. 65. Some terms are already determined by the law itself, so any possibility to interpret them can occur. The courts seek to reach a fair and reasonable outcome based on all the facts of the case. The circumstances attending the formation of the contract should be taken into

[8] Posner (2004), p.27.
[9] Sharon Steel Corp. V. Chale Manhattan Bank, 691 F.2d 1039, 1051 (2d Cir. 1982).
[10] Dispatch Automation, Inc. v. Richards, 280 F.3d 1116, 1119 (7th Cir. 2002)

consideration as well. An example may be found in art. 65 § 2 of the Polish Civil Code which says that parties' intentions and a purpose of the contract should be considered first rather than the literal meaning of a contract. The parties are not always law experts and the name they give to a contract or some terms they used in it may not be correct or exact enough and may not express what the parties really intended. To determine the consequences of a contract one should investigate the text of a contract in order to find the real purpose of the parties. A contract should be then the subject of functional analysis, not linguistic. In case the parties made a certain type of a contract but they gave it a different name because they were not careful enough or they wanted to mislead someone, the legal consequences shall not be based on contract's name but on the content. If a contract is not clear enough and the type of contract is impossible to be determined the court may ask the parties about their intentions and investigate the other circumstances. A role of a wording of a contract is hereby diminished in comparison to Anglo-Saxon manners of interpretation. [11]

V. Conclusion

People have probably been trading since the origin of humanity. With the appearance of transactions other than simultaneous, the trade has begun to be based on a promise of a future performance. [12] Nowadays, such a promise is a contract enforceable by law. Freedom of contracts was established in order to give people the best possibilities to organize their economic activity. Broadly speaking, the *laissez-faire* doctrine encouraged free trade and business development. Nonetheless, contracts cannot ignore neither real-life situations nor ethics and values. Each society or state determines their principles concerning the above. These principles should be considered as factors that determine contract interpretation and limit parties' performance, therefore they have great impact on the law system and economic life. Posner's paper is very helpful in understanding how complex can be an interpretation of a particular contract. Furthermore, it presents the influence of the interpretation rules on a general character of a given law system due to the fact that it reflects its principles and values. The paper is as well useful for better understanding of a contract-making process. Analysis of interpretation rules may indicate the parties and the most important elements of a contract-making process as well as the possible consequences of including particular conditions and clauses in a contract. Parties, aware of all those issues, will be able to avoid not favorable situations. Posner's observations included in the paper are an incentive to

[11] Lando (1999), p. 5.
[12] Stroiński (2006).

conduct a further analysis of law and economics to determine whether law systems as entities are efficient in categories of social and economic utility. Subsequently, while taking into consideration his remarks about the deep differences between Common Law countries and Code of Law countries we may indicate different research tools and objects. Simplifying, in the former court's activity, jury's behavior and everything what is connected with wording of a contract are the most significant factors. Therefore, a best way to prepare an efficient contract would consist of a careful and smart drafting. In the latter there are parliament-made law and the Supreme Courts judgments. The key to prepare a 'good' contract would be an appropriate application of the standard clauses, recognized by the system and the doctrine. Except from main issues mentioned before, the law culture, social conditions and institutions can be taken into consideration as the factors having influence on economic performance. Law does respect values and habits of a given society, this fact, once more, shows the linkage between law and economics and institutional economics.

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