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The State of Debate Over the Incorporation Strategy in Contract Law

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Contracts in principle can be complete: they can condition the obligations of the contracting parties in every possible future state of the world. In practice contracts ordinarily are left incompletely specified for a variety of reasons, including strategic behavior, cognitive limitations of the parties, nonlegal substitutes for enforcement, or simply because the parties do not find that a more complete specification is worthwhile. Enforcement of complete contracts requires rules for interpreting their terms. The enforcement of incomplete contracts requires these rules as well as rules supplying terms–gap fillers–that the parties have not provided. A question exists as to what both sorts of rules ought to be. In broad terms, there are two different answers proposed to this normative question about contract law. One is "formalism." Formalism recommends that the terms of contracts be interpreted according to their literal ("plain") meaning and that gaps be filled by a few binary default rules.[1] The other answer is "contextualism." As the label suggests, contextualism recommends that contract terms be interpreted according to the meaning given them by the contracting parties, as informed by the circumstances of the their contract. It also proposes that default rules be supplied that take into account the context of the particular parties' bargain or facts about the contexts of most parties' bargains.

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[1]For recent formalist proposals, see Robert E. Scott, The Death of Contract Law, 54 U. Toronto L. J. 369 (2004); Alan Schwartz & Robert E. Scott, Contract Theory and the Limits of Contract Law, 113 Yale L. J. 541 (2003); Omri Ben-Shahar, The Tentative Case Against Flexibility in Commercial Law, 66 U. Chi. L. Rev. 781 (1999); Richard A. Epstein, Confusion about Custom: Disentangling Informal Customs from Standard Contractual Provisions, 66 U. Chi. L. Rev. 821 (1999).

Although formalist proposals invoke but do not define literal or "plain" meaning, literal meaning plausibly can be understood as sentence meaning. It is a function of the semantic components of the terms of the sentence and the sentence's syntax. Contextual cues do not contribute to the literal meaning of the sentence. They are pragmatic features that determine the meaning a speaker or writer attributes to the spoken or written sentence. Nothing in what follows depends on the details of this characterization of literal meaning. The characterization serves to distinguish formalism from contextualism, discussed above.

The incorporation strategy is a type of contextualism. It proposes that both interpretive and default rules incorporate the norms of commercial practice, including the course of performance and dealing of contracting parties, and relevant trade usage.[2] Because business norms are type of behavioral context in which parties contract, incorporation is a subset of contextualism. Much of domestic and international commercial law adopts the incorporation strategy. It is apparent in sales law, such as Article 2 of the Uniform Commercial Code (UCC) and the United Nations Convention on Contracts for the International Sale of Goods (CISG). Proposed amendments to Article 2 of the UCC further extend the role of commercial practice in Article 2's interpretive rules.[3] Model laws and proposed international conventions governing financial leasing and factoring also implement the incorporation strategy, as do a number of international arbitral rules.[4] Even domestic and international letter of credit law, a set of paradigmatically formalist rules, incorporate commercial norms. As a descriptive matter, much of commercial law looks less like the law of negotiable instruments and more like sales law. The debate over incorporation is whether contract law, understood broadly, ought to adopt the incorporation strategy or formalism.

The way in which the contemporary incorporation debate has proceeded leaves its

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[2]See Clayton P. Gillette, The Empirical and Theoretical Underpinnings of the Law Merchant, 5 Chi. J. Int'l Law 157 (2004); Jody S. Kraus & Steven D. Walt, In Defense of Incorporation, in The Jurisprudential Foundations of Corporate and Commercial Law 193 (J.S. Kraus & S.D. Walt eds. 2000).

[3]See amended U.C.C. § 2-319 Reserved, Comm. (2005) (definitions of delivery terms deleted; absent express agreement on their meaning, they "must be interpreted in light of an applicable usage of trade and any course of performance or course of dealing between the parties").

[4]See, e.g., UNIDROIT Convention on International Financial Leasing, art. 6 (1988); UNIDROIT Convention on International Factoring, art. 4 (1988); Proposed UNIDROIT Convention on International Interests in Mobile Equipment (tent. draft 1997); Rules of Arbitration of the International Chamber of Commerce, art. 17(2) (2000) (trade usage); cf. UNIDROIT Principles of International Commercial Contracts art. 1.8(2) (1994).

conclusion inconclusive. Opponents agree on the normative criterion for the evaluating interpretive and default rules: efficiency, understood as the maximization of the ex ante value of the contractual surplus. They disagree over whether formalism or incorporation maximizes contract value, often based on an assessments of different relevant variables. In this respect the debate resembles the law and economics literature on the efficiency of different remedies for breach. The literature shows that the choice of remedy can affect the decision to breach, the care with which contractual performance is undertaken, the extent of investment, mitigation, choice of contract, and renegotiation. A damages remedy that is efficient with respect to one of these variables need not be efficient with respect to the others.[5] None of the familiar remedies is likely to be efficient, taking into account the effect of all of these variables on the parties' incentives. The literature concludes that the choice of an efficient among traditional remedies is similarly inconclusive or indeterminate.

This Article briefly argues that conclusiveness is not the proper test for the choice between formalism and incorporation. A comparison between the choice of remedy and choice

[5]See Richard Craswell, Against Fuller and Perdue, 99 U. Chi. L. Rev. 99, 108-110 (2000); Contract Remedies, Renegotiations, and the Theory of Efficient Breach, 61 S. Cal. L. Rev. 629 (1988). The literature is summarized in Aaron S. Edlin, Breach Remedies, in 1 The New Palgrave Dictionary of Law and Economics 174-78 (P. Newman ed. 1998).

of interpretive and default regime is misplaced. The literature on efficient remedies asks a different question than is asked in the debate over incorporation. The former seeks to identify the efficient remedy from among a potentially indefinitely large set, taking into account a range of variables. Debate over incorporation is over the choice among a small set of possible interpretive and default regimes, whether or not they are implemented currently in law. More important, the standard of adequacy for recommending interpretive and default regimes implicit in the comparison is inappropriately demanding. A more moderate standard tentatively favors incorporation. The Article is in four parts. Part I makes some preliminary points about contract theory generally. Part II rehearses an economic case for the incorporation strategy. Part III describes and rejects prominent arguments against incorporation. Part IV describes a standard of adequacy for normative proposals about rule design and tentatively argues that the case for incorporation described in Part II satisfies them. A conclusion summarizes the state of debate over incorporation.

I. Preliminary Points

Formalism and the incorporation strategy set different interpretive and default rules. Formalism directs courts to construe contract terms according to their literal meaning and to supply a few dichotomous gap fillers. Incorporation requires them to take into account trade usage, course of performance and course of dealing–business context--both in interpreting contract terms and supplying default rules applicable to the contract. The two approaches compete only if they cover the same range of transactions and an interpretive regime and default rules must be selected. If the approaches apply to different sorts of transactions, a choice between approaches is unnecessary; if a set of interpretive and default rules need not be selected,

the choice is both unnecessary and unimportant. Three preliminary points suggest that the approaches compete and that an interpretive regime and set of default rules must be selected.

First, the selection of an interpretive regime is unavoidable. This is true not only for the obvious reason that the contracting parties' obligations turn on their undertakings under the contract. In addition, interpretation is needed even to determine that there is a gap in the contract. After all, a gap in a contract exists, to be filled by a default rule or left unfilled, only if the contract's terms leaves the matter unaddressed. For example, a contract leaves the effect of intervening events on the seller's performance obligation unaddressed only if terms describing the delivery obligation are interpreted as unconditional. Even a default rule barring courts from supplying a gap-filling term requires construing the terms of the contract. Thus, interpretive rules are in a sense prior to default rules. Interpretive rules are also needed to characterize a contract as "complete" or "incomplete." In a recognizable sense of the notion, a contract is complete when it assigns obligations across every possible future state of the world.[6] Terms in a contract may assign the same obligations to the parties across an entire range of distinguishable

[6]The notion of completeness is not uniform. Completeness sometimes is defined by state-differentiation (assigning contractual obligations in every possible future state of the world) and sometimes by ideal-state differentiation (the assignment of obligations the parties would make across possible states if they had all payoff-relevant information available to them). For an example of the former notion, see Oliver Hart, Firms, Contracts, and Financial Structure 22 (1995) ("comprehensiveness"); for identification of the latter notion, see Karen Eggleston et al., The Design and Interpretation of Contracts: Why Complexity Matters, 95 Nw. L. Rev. 91, 100 (2000); Alan Schwartz, Incomplete Contracts, in 2 The New Palgrave Encyclopedia of Law and Economics 277, 277 (P. Newman ed. 1998). The point in the text relies on the former notion.

contingencies (e.g., price, risk of loss). Whether the contract distinguishes between future states of the world and allocates invariant obligations across them obviously requires interpretation of the contract's terms.

Second, the ability of parties to contract around interpretive and default rules does not make the debate between formalism and incorporation irrelevant.[7] Because opting out of an interpretive and default regime can be costly individually and in the aggregate, the size of contracting costs induced under formalism and incorporation remains important. The value of the contractual surplus is reduced even for parties who prefer another regime but decide that selecting it either is not cost-justified or otherwise inaccessible. More generally, an emphasis on transactional planning, not rule design, does not avoid consideration of interpretive regime and default rules. The ability of parties to select between formalist and incorporation regimes by contract still requires them to compare the ex ante and ex post costs of each regime. An estimate of the size of these costs informs the design of legal regime. For instance, the parties' preference for a formalist regime over incorporation or vice versa, based on estimates of these costs, provides some evidence for the superiority of the preferred regime.

[7] Avery Katz takes this position; see Avery Wiener Katz, The Economics of Form and Substance in Contract Interpretation, 104 Colum. L. Rev. 496, 511 (2004) [hereinafter, "The Economics of Form"]; Avery Wiener Katz, Taking Private Ordering Seriously, U. Pa. L. Rev. 1745 (1996).

Third, and more controversial, interpretive and default rules apply to all transactors and transactions. In other words, the domain of contract law is general: the selection of interpretive and default rules does not depend on the type of contracting party. To see this, assume that the only parties to a contract are either individuals or "firms," where the latter refers to entities having a separate legal personality.[8] In a sales transaction between an individual and a firm, either party may be a seller or buyer. Thus, there are four possible sorts of contracts arising from the transaction (listing the seller first; the buyer next): (1) a firm-firm contract; (2) an individual-individual contract, (3) a firm-individual contract, and (4) an individual-firm contract.

If interpretive and default rules should differ according to the type of contracting party, then the rules applicable the firm-firm contract differ from those applicable to the other contracts. Should they differ? Schwartz and Scott argue that they should. They do so by characterizing the sort of law ordinarily applicable to each sort of contract. Firm-firm contracts are governed by the UCC or contract law; individual-individual contracts are governed by family or real property law; firm-individual contracts by consumer protection, securities or real property law;

[8]See Reinier R. Kraakman et al., The Anatomy of Corporate Law: A Comparative and Functional Approach 7, 9 (2004).

and individual-firm contracts by labor law.[9] Schwartz and Scott therefore conclude that contract theory is restricted in its scope.

The argument for restricting the scope of interpretive and default rules is weak. Descriptively, the character of the law ordinarily applicable to each sort of contract seems inaccurate. Article 2 of the UCC applies to transactions for the sales of goods between individuals. The identification of characteristic law also ignores the reliance in these areas on general contract law. Contract law still applies to real estate and labor law, for instance, even when particular rules alter otherwise generally applicable principles of contract (e.g., "at will" contracting, fresh consideration). More important, as a normative matter, the limited competence of courts argues against restricting the scope of interpretative and default rules. The distinction between individuals and firms is easy enough for courts to draw reliably. But the selection of the interpretive and default regime appropriate to a transaction is more likely to be subject to error. The characteristics of individuals may not differ systematically from those of firms. Individuals, like firms, may be sophisticated, not risk-neutral or subject to cognitive biases or limitations, depending on the transaction or circumstances. Even if the relevant characteristics of firms and individuals differ, courts may not be in position to discover the difference reliably. A single interpretive and default regime, applicable to both individuals and firms, avoids judicial error in the regime choice. Schwartz and Scott plausibly assume that the

[9]See Schwartz & Scott, supra note 1, at 545-547. The taxonomy above is Schwartz & Scotts'; see id.

courts and law-producing bodies have limited resources and expertise with which to select interpretive and default regimes. The same assumption argues for a single interpretive and default regime applicable to both individuals and firms. Incorporation recommends that the interpretive and default regime include commercial norms.

II. A Case for the Incorporation Strategy

The choice of an interpretive and default regime can affect a range of variables including the choice of contracting partner, type of contract, the cost of performance, the decision to breach, and the costs of administering the regime's rules. Historically, contextualism has been defended on noneconomic grounds, as the most reliable way of discerning the contracting parties' intentions.[10] An economic case for incorporation instead recommends the strategy based on an assessment of three variables affecting the contract and its performance, and enforcement: specification costs, judicial error costs, and administrative costs. It assumes that an interpretive and default regime ought to be adopted if it minimizes the sum of these costs for most contracts. (Part IV defends the use of partial analyses to make normative recommendations about rule design.) The case for incorporation argues that, for most contracts and contracting parties subject to a general interpretive and default regime, incorporation minimizes the sum of specification, error and administrative costs. Although there is an inevitable tradeoff between specification and error costs, incorporation reduces specification costs significantly more than it increases error and administrative costs. Thus, the case consists of a claim about the characteristics of parties and contracts subject to an interpretive and default

[10]See, e.g., Arthur L. Corbin, The Interpretation of Words and the Parol Evidence Rule, 50 Cornell L. Rev. 161, 189 (1965); 3 Arthur L. Corbin, Corbin on Contracts § 542 (1950); Katz, The Economics of Form, supra note 7, at 520-521.

regime and an assessment of relevant specification, error and administrative costs associated with incorporation. The following analysis defends the claim and the assessment.[11]

1. *Characteristics of Contracts and Parties*. Interpretive and default rules are general; they apply to all contracts involving individuals and firms. Specific exceptions can be made for particular types of contracting parties or transactions, such as merchants or consumer transactions,[12] but the rules are otherwise generally applicable. This is the preliminary point made above the scope of interpretive and default regimes. Because their scope is general, the choice of regime turns on the salient characteristics of parties and contracts to be governed by the regime selected. The range of these characteristics is broad. As to contracting parties, individuals may be risk-averse and subject to cognitive biases or limitations.[13] Both firms and individuals may contract under asymmetric information. Even risk-neutral individuals may

[11]A slightly different analysis appears in Kraus & Walt, supra note 2.

[12]See, e.g., unamended U.C.C. §§ 2-202(2), 2-314(1) (merchant provisions); 9-108(e)(2), 9-620(g) (2005) (consumer goods or transactions provisions).

[13]Arlen et al. present evidence questioning the operation of a cognitive bias (the endowment effect) in corporate contexts; see Jennifer Arlen et al., Endowment Effects Within Corporate Agency Relationships, 31 J. Legal Stud. 1 (2002). Korobkin argues for its operation even in such contexts, while acknowledging the mixed experimental results; see Russell Korobkin, The Endowment Effect and Legal Analysis, 97 Nw. U. L. Rev. 1227 (2003). For a skeptical assessment of the significance of experimental evidence of cognitive bias for the design of legal rules, see Steven Walt, Liquidated Damages After Behavioral Law and Economics, 6 Virg. J. 98 (2003).

face different contracting costs than firms. The preferences of individuals and firms presumably are heterogenous, as reflected in the variety of contract terms tailored for specific transactions.

The range of type of contracts also is broad. Both discrete contracts as well as installment and long-term contracts are governed by general rules of contract law. They also may involve large or small prices between contracting parties whose performance cannot be observed or verified by potential contracting partners. This means that interpretive and default rules govern contracts in which the conditions for reputational sanctions to operate are absent. Article 2 of the UCC is designed to be fit for the vast range of different contracts for the sale of goods involving parties with diverse preferences over terms. The variety of contractor and contract is reinforced when the contracts are international. Although CISG ordinarily will not apply to international sales contracts involving consumers,[14] it applies to individuals and firms, and a wide range of different types of contracts for the sale of goods. Article 2 and the CISG are examples of the general scope of interpretive and default rules. They reflect the broad range of characteristics of contractors and contracts covered by a general interpretive and default rules.

2. *Specification Costs.* Specification costs are costs contracting parties incur in recognizing a need to provide a term, agreeing to its formulation, and providing the term.

[14]See CISG art. 2(a).

Parties bear specification costs under formalism because they must supply a term for it to apply to their contract. Unless the desired term is supplied by the few bright-line defaults, their contract not include the term. Parties who prefer to give a term a meaning consistent with applicable business norms (a "domain-specific" meaning) but inconsistent with the term's literal meaning must do so. Otherwise, a court will not give the term of the contract that meaning. Specification costs are incurred in providing for a domain-specific meaning. Accordingly, parties will select a less efficient over a more efficient, domain-specific term whenever marginal specification costs exceed marginal increase in contract value from supplying the more efficient term. An incorporation regime produces lower specification costs than under formalism. This is because terms are given their domain-specific meaning, unless the parties provide otherwise. In addition, commercial norms serve as defaults, thereby saving parties the cost of supplying the term in the first place. For both reasons, incorporation saves parties the cost of specification costs by allowing them to use domain-specific meanings customized to suit the need of the contracting context.

The size of the reduction in specifications costs realized by incorporation is likely to be significant. If the domain-specific meaning coincides with the literal meaning of a term, the principal specification cost incurred under formalism is only the cost of supplying the term. Additional specification is unnecessary because a court will give the term its literal meaning, and this suits the parties. In this case the savings in specification costs might be modest. But domain-specific meanings probably diverge from literal meaning in many cases. Literal meaning is the meaning of the term grasped by competent speakers of the relevant language; it is "dictionary" meaning. As such it is not directly responsive to the demands of commercial

parties or contracts and therefore need not reflect changes in predominant contracting contexts. Thus, domain-specific and literal meaning frequently will diverge. In response to transportation and technological conditions prevailing in the American lumber industry in the early 20th century, a "2 by 4" refers to a piece of lumber no less than between 1 5/8 inches by 3 5/8 inches. In international letter of credit banking practice, an invoice conforms to the credit when it indicates a quantity within five percent of the quantity called for by the credit (unless the credit expressly requires a precise quantity).[15] The meaning of these domain-specific terms differ from their literal meaning. The relative isolation of literal meaning from commercial practices suggests that the literal and domain-specific meanings frequently will diverge.

[15]See I.C.C. International Standard Banking Practice (ISBP) for the Examination of Documents Under Documentary Credits, Pub. No. 645, art. 69 (2002); cf. id at 9 (publication "reflects" standard banking practice). For an early recognition of the general divergence between literal and domain-specific meaning in letter of credit practice, see John Honnold, Letters of Credit, Custom, Missing Documents and the *Dixon* Case: A Reply to Backus and Harfield, 53 Colum. L. Rev. 504, 504 (1953).

Two other considerations suggest that incorporation significantly reduces specification costs. First, specification costs per contract will be high in many instances. The costs to parties of negotiating and formulating terms vary considerably, both between individuals and firms. An assumption of low specification costs is unsafe given differences in sophistication among parties and the unsuitability of form contracts for individualized transactions. Even for firms, the cost of precisely tailoring terms to a contract sometimes remain high. Letter of credit applicants frequently agree to waive their right to insist that a documentary presentation strictly comply with the terms of the credit.[16] The waiver suggests that the terms of the initial reimbursement agreement with the letter of credit issuer were too specific: the parties intended to treat the presentation by the beneficiary of the credit as complying. Further, in many low-value contracts low specification costs will exceed the benefit of specification, weighted by the probability of litigation. The contracting costs to firms of drafting default rules provided by state corporate law may be trivial when amortized over the transactions conducted using the corporate form.[17] However, specification costs are not trivial over the range of low-value contracts controlled by contract law's general interpretive and default rules. For these sorts of contracts, incorporation reduces the specification costs have to incur to get terms with enforceable meanings they prefer.

In addition, specification costs are large when aggregated across transactions. The relevant measure of the size of these costs obviously sums specification costs over all of the

[16]Cf. Robert M. Rosenblith, Seeking a Waiver of Documentary Discrepancy From the Account Party: Unexplored Legal Problems, 56 Brooklyn L. Rev. 81, 85 (at least 50 percent of presentations noncomplying); James Byrne, 3 Letter of Credit Update 7 (July 1987) (about 90 percent noncomplying).

[17]See Bernard S. Black, Is Corporate Law Trivial?: A Political and Economic Analysis, 84 Nw. U. L. Rev. 542, 557 (1990) (cost to firms of contracting around corporate default rules "not very important").

contracts governed by incorporation. Because the scope of an incorporation regime covers a wide range of contracts, the reduction in specification costs is high, even if the per contract specification cost is low. True, a precise measure of the savings in specification costs must take into account the specification costs incorporation forces parties to incur when they do not want otherwise applicable domain-specific meanings to control their contract. This requires an estimate of the distribution of parties with such preferences within the population of contracting parties, as well as their costs of contracting around incorporation.[18] But the number of low-value discrete contracts, as well as the variety in the characteristics of the contracting parties, suggests that the specification costs avoided under incorporation is significant.

Second, incorporation saves parties the cost of taking precautions otherwise needed to assure that domain-specific meanings will control a term. Formalism forces parties to take measures to avoid the risk that a term of their contract will be given a literal meaning. It also forces them to invest in supplying terms that will not be supplied by the few gap-filling defaults formalism otherwise provides. Given that parties incur a certain cost in undertaking such

[18]The concession is important in the literature concerning the optimal measure of consequential damages; see, e.g., Barry E. Adler, The Questionable Ascent of *Hadley v. Baxendale*, 51 Stan. L. Rev. 1547 (1999); for the relevance of contracting costs to the selection of default rules, see Ian Ayres, Making a Difference: The Contractual Contributions of Easterbrook and Fischel, 59 U. Chi. L. Rev. 1420 (1992).

measures while litigation over the term or gap is only is a cost discounted by the probability of litigation, they often will not invest to avoid the risk. Precautionary measures are particularly expensive for terms in complex contracts where parties might not even be aware that they are relying on domain-specific meanings. Again, for individuals and perhaps for some firms, the divergence between domain-specific and literal meanings might not even be apparent. Incorporation does not impose the cost of these precautionary measures on parties because terms are given domain-specific meanings and defaults, unless the parties provide otherwise.

The precautionary component of specification costs is important even when the cost of formulating the domain-specific meaning of a term is low. For instance, it is plausible to assume that most contracting parties assign a literal meaning to most of the terms of their contracts. There will be relatively few material or non-material terms to which they want to assign domain-specific meanings.[19] However, it cannot be concluded that the costs of contracting for the domain-specific meanings of the few such terms is correspondingly low. The conclusion holds only for formulation costs. The costs of identifying and negotiating for domain-specific meanings for the few identified terms still can be high. This is true whenever the divergence between literal and domain-specific meanings are not transparent to the parties. In such cases term by term comparison can be costly–perhaps even impossible to undertake. To be sure, incorporation does not relieve parties of all precautionary costs. They still have to take measures to assure that error-prone adjudicators ex post will apply the desired domain-specific meaning. But parties wanting assurance that their terms will be given the correct literal meaning must take costly precautions as well. There is no reason to assume a

[19]See Schwartz & Scott, supra note 1, at 585 n.83.

priori that such costs in the former case exceed those in the latter. Thus, this element of precautionary cost is constant between formalism and incorporation.

2. *Adjudicatory error costs*. Adjudicatory error reduces contract value by the expected costs of incorrect adjudication. Expected adjudicatory error costs in turn are measured by the probability of an adjudicator incorrectly interpreting or supplying a default term, discounted by the impact of the error on the value of the contract to the affected party. The incorporation strategy increases both the variance and mean adjudicatory error with respect to the interpretation of terms. It increases variance because it adds additional conditions for interpreting terms that occasion mistake. Mean error rates in adjudication also frequently increases since errors are not symmetrically favorable and unfavorable to contracting parties. This is because the presence of precise contract terms (e.g., fixed price, quantity) often limit the extent to which a party can benefit from a favorable error.[20] Thus, incorporation increases error cost for both risk-averse and many risk-neutral contracting parties compared to formalism.

As to interpretation, adjudicators and parties can misconstrue terms of the contract under any interpretive regime. Under formalism, however, the only source of interpretive error is the mistaken identification of literal meaning. Incorporation adds a second uncorrelated source of error: the identification of a specific domain within which the term's meaning is

[20]The general observation is made by Schwartz & Scott, supra note 1, at 578-581; cf. Ben-Shahar, supra note 1, at 813.

determined. This increases the variance of interpretive error. The second source of error increases the mean error rate when a contract term prevents the error from symmetrically favoring a party. In such cases the effects of favorable and unfavorable error do not cancel each other: the error is systematic and reduces the expected value of the contract to the party unfavorably affected by it. For example, consider the term "full set." The literal meaning of the term describes a collection consisting of all of the members of a group of items. Suppose a letter of credit calls for a documentary presentation of the "full set" of bills of lading. Custom among international letter of credit issuers understands "full set" to mean "the complete set of bills of lading or an incomplete set accompanied by an indemnification in favor of the issuing bank." Domestic issuers of letters of credit give the term its literal meaning. A court relying on literal meaning could make a mistake in interpreting the term "full set of bills of lading" in the credit. The only source of the mistake here is the identification of the term's literal meaning. Two sources of mistake are possible for courts adopting the domain-specific meaning of the term: identification of the relevant domain in which the term is given meaning, and the meaning of the term within that domain. Thus, the court could misidentify the relevant domain as one involving domestic issuing banks, in addition to wrongly interpreting the meaning of "full set of bills of lading" among international issuing banks. This increases the variance of interpretive error. The mean error also increases because the issuing bank does not benefit from an incorrect finding that banking practice of domestic issuers applies. Here "full" means "complete," so the issuer is not favored by the error: it must pay when a full set of bills of lading are presented. Because incorporation makes possible two sources of interpretive error while formalism only one, incorporation increases interpretive error costs.

Adjudicatory error associated with gap-filling also is higher under incorporation than under formalism. This is simply because incorporation allows gap-filling by business norms while formalism restricts default rules to a few bright line rules. Business norms may be vague in content or scope; even when crisp, parties may not intend some business norms to be legally enforceable. They are sources of mistake and therefore variance in outcomes of litigation. Since business norms do not form the basis of bright line rules, formalism rejects them as default rules and therefore reduces the number of defaults about which adjudicators can err. Incorporation, by including business norms in default rules, increases error compared to formalism by increasing the number of defaults about which an adjudicator can be mistaken. The increase therefore is a consequence of the requirement that courts fill more gaps than permitted by formalism. This has nothing to do with the regulatory form by which the incorporation strategy supplies gap-filling terms. The strategy might supply these terms by either ex ante rules or ex post standards incorporating business norms.[21] It could make such rules or standards more precise or less differentiated in content. Whichever regulatory form it takes, incorporation increases the occasion for error and therefore error costs because it requires

[21]For the distinction between rules and standards according to whether the content of a prescription is provided before adjudication or by it, see Louis Kaplow, General Characteristics of Rules, 5 Encyclopedia of Law and Economics 502 (B. Bouckaert & G. De Geest eds. 2000); Rules versus Standards: An Economic Analysis, 42 Duke L. J. 557 (1992). The UCC and the CISG both regulate contracts by standards incorporating business norms; see, e.g., unamended U.C.C.§§ 1-201(3), 1-205(4); CISG art. 9(1), (2).

gap-filling by business norms while formalism does not.

The next question is whether the increase in adjudicatory error costs exceeds the significant reduction in specification costs under incorporation. Two reasons suggest not. First, incorporation regimes as implemented can restrict the use of business norms to reduce error costs. For instance, burdens of proof can be assigned to reduce erroneous findings of trade usage, course of performance or course of dealing. Similarly, legal standards defining these business norms can be strengthened to the same effect. For instance, trade usage could be considered part of the contract only if it is long-established and salient.[22] Or a course of performance could be deemed not to alter or supplement the terms of the contract when it contains a no-waiver clause.[23] An extreme measure would use expert courts on the order of the Delaware Court of Chancery or the Federal Circuit, or merchant juries. None of these devices reduce error below that produced under formalism: literal meaning and "no enforcement"

[22]Cf. U.C.C. § 1-205 Comm. 5 ("The ancient English tests for 'custom' are abandoned in this connection. Therefore, it is not required that a usage of trade be 'ancient or immemorial', 'universal' or the like"); CISG art. 9(2) (usage in international trade which is "widely known" and "regularly observed" in the particular trade).

[23]For Article 2 of the UCC's unclear treatment, see Clayton P. Gillette & Steven D. Walt, Sales Law: Domestic and International 96-98 (2d ed. 2002).

defaults still remain less likely to be incorrectly determined. They do, however, reduce the rate of adjudicatory error without undermining the incorporationist character of the interpretive and default regime or sacrificing significant savings in specification costs.

Second, contracting parties themselves can reduce adjudicatory error by elaborating on particular terms. If adjudicators are only moderately incompetent, so that parties can increase the chance of correct interpretation by taking some action, parties have a range of alternatives available to reduce adjudicatory error on a term by term basis. Monitoring the contracting partner, precise definition of terms combined with express displacement of business norms, recitals of norms that are not intended to be legally enforceable, and early suit to preserve evidence are ways that make it more likely that the contract will be construed correctly. Parties will select from among them the cost-effective means of reducing adjudicatory error. Risk-averse parties will invest to reduce the variance in outcomes produced by adjudicatory error. The optimal investment for them is some function of the cost of error and minimization of its risk. Risk-neutral parties will invest to reduce the mean rate of adjudicatory error to which they are exposed.

The contractual elaboration of particular terms can be a cost-effective method of reducing adjudicatory error. Where an incorrect construal of a particular term has no effect on the value of the contract to a party, the party will not invest in reducing legal error. Taking measures to reduce the adjudicatory error of construing material terms is costly,[24] particular given the earlier acknowledgment of the limited ability of parties ordinarily to vet all of the terms of their contract for a divergence in literal and domain-specific meanings. But contractual elaboration of

[24]See Ben-Shahar, supra note 1, at 814-815.

particular terms anticipated to be error-producing is a salient and often superior to other ways of reducing the chance of error. It saves the party the presumably greater cost of monitoring all aspects of the other parties' performance or repeated suits over an installment or long-term contract, for example. Elaboration of particular terms increases a parties' contracting costs only with respect to the term elaborated upon while still preserving the significant savings in specification costs with respect to remaining terms.

4. *Administrative costs.* The administrative costs of an interpretive and default regime include the cost of construing and enforcing contracts under it. Regimes with simpler interpretive and rules produce lower administrative costs than regimes with more complex rules.

One measure of simplicity is the accessibility of information a regime requires to construe the contract and set default rules: A simple regime is one whose interpretive and default rules are easy for adjudicators to understand and apply to a contract.[25] The information adjudicators require is readily accessible to them. On this rough measure, formalism is a simpler regime than incorporation. Formalism requires only knowledge of the literal meaning of the terms of the contract and verifiable information needed to set the few default rules. Incorporation requires knowledge of applicable business norms both to interpret terms and set default rules. Competent speakers know or can easily determine literal meaning, and verifiable information by its nature is observable information that can be communicated to the adjudicator. Thus, the administrative costs under formalism are comparatively low. Incorporation requires

[25]For a wide range of different notions of simplicity, see Eggleston, supra note 6, at 97-98; Richard A. Epstein, Simple Rules for a Complex World 24-29 (1995); Peter H. Schuck, Legal Complexity: Some Causes, Consequences and Cures, 42 Duke L. J. 1 (1992). The notion of simplicity in the text is that of accessibility to information: ease of understanding and application. Other notions turn on the measures of differentiation, technicality and frequency of application.

adjudicators to interpret contract terms and set default rules according to applicable business norms. The existence and content of applicable business norms are not always transparent, and adjudicators do not have easy or reliable access to them. So incorporation is more complex than formalism and therefore in a straightforward way induces higher administrative costs than the latter.[26]

[26]Administrative costs are an externality that the contracting parties impose on courts. Formalism, by

interpreting contract terms by their literal meaning and recognizing few defaults, encourages parties to supply the terms and context-sensitive understandings that they want to govern their contract. See Schwartz & Scott, Limits of Contract Law, supra note 1, at 590 n.95. Otherwise, they risk not having their contract subject to the terms or interpretation they prefer. Thus, formalism forces parties to internalize much of the cost of their contracting behavior. In this way, formalism, like the Statute of Frauds, shifts a portion of proof costs from courts to the contracting parties, thereby reducing the relevant externality. Cf. Ian Ayres & Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 Yale L. J. 87, 95-97 (1989). However, a reduction in proof costs borne by courts is not sufficient to favor formalism. The reduction in addition be must be optimal. Incorporation argues that specification costs for many types of contracts and contractors are high. If so, these costs are unlike the proof costs internalized by contracting parties when their contract is controlled by the Statute of Frauds. Memorializing the few terms required under the Statute (quantity, signature, "sufficient" evidence of a contract under U.C.C. § 2-201(1)) has correspondingly few specification costs. High specification costs are incurred by parties in providing for the range of other terms and interpretive guides. Unlike the Statute of Frauds, courts might be better able to supply these terms and guides based on business norms than the parties. If so, proof costs incurred in determining business norms are optimally allocated to courts. This represents a subsidy to the contracting parties, which can be addressed by taxing them according to their use of the courts.

But the question is the size of the increase in administrative costs under incorporation. Because incorporation is a subset of contextualism that requires only contextual evidence of business norms, adjudicators do not incur the cost of determining other features of the contracting context. As with error costs, its administrative costs are unlikely to be significantly higher than under formalism. This is because incorporation strategies can be implemented to reduce administrative costs. As with adjudicatory error, heightened burdens of proof and elements of business norms can be defined to make the determination of business norms easier for adjudicators. An example of the latter would be the requirement that a custom or course of dealing, for instance, be significantly entrenched to be apparent to a court.[27] A requirement of entrenchment increases the court's ability to detect applicable business norms and reduces the administrative costs incurred in doing so.

[27] See, e.g., Amtsgericht Duisburg, 49 C 502/00 (April 13, 2000), 1 UNILEX D.2000-18 (granting credit on only two occasions do not amount to a practice established between the parties).

Gillette finds that adjudicators applying the CISG condition determinations of trade usage on verifiable variables that do not require technical expertise to establish.[28] His finding suggests that the CISG's incorporation regime, as implemented, recognizes trade usage only when it is easily accessible to adjudicators. In this way implementation of the CISG's incorporation strategy produces low administrative costs.[29] My reading of case law applying the CISG does not reach the same conclusion. Adjudicators do not uniformly set contract terms based on verifiable information. True, some courts and arbitrators recognize trade usage when it verifiable, as Gillette finds. For instance, INCOTERMS expressly defines delivery terms and their corresponding abbreviations, and international sales contracts frequently incorporate it expressly or by reference. In both cases, the custom of incorporating INCOTERMS combined with the express definition makes it a verifiable customary standard. Access to the custom standard is easy.[30]

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[28]See Gillette, supra note 2, at 173-178.

[29]Id. at 178.

[30]See Geneva Pharmaceuticals Technology Corp. v. Barr Laboratories, Inc., 201 F. Supp.2d 236, 281-282 (S.D.N.Y. 2002); Gillette, id at 177-178.

But adjudicatory practice under the CISG concerning other issues is not uniform. Some courts disagree about trade usage; others supply terms based on unverifiable variables. Some courts find a trade usage to the effect that silence in the face of a written confirmation of an agreement constitutes acceptance of its terms while others do not.[31] In other cases adjudicators have supplied terms based on information inaccessible to them. A few courts determine that unspecified trade usage sets the rate of pre- and postjudgment interest on damage awards.[32] The interest rate is not setting according to verifiable information about prevailing market prices (e.g., LIBOR). Other adjudicators set the applicable rate of interest as full compensation, according to "general principles" underlying the CISG.[33] Full compensation requires unverifiable information about the contracting parties' opportunity costs–unverifiable information. The relatively sparse case law under the CISG does not show a clear trend of reliance on verifiable information in supplying terms. The point remains, however, that the incorporation strategy could be implemented to keep administrative and error costs low. When well implemented the administrative and error costs need not be appreciably higher than they are under formalism. Case law under the CISG at most shows that incorporation sometimes can be

[31]Cf. Oberlandesgericht Saarbrucken, No. 1 U324/99-59 (February 14, 2001) , <http://cisgw.3.law.pace.edu/cases/010214g1.html>, with Oberlandesgericht Dresden, 7 U 720/98 (July 9, 1998), <http://cigsw.3.law.pace.edu/wais/db/cases2/980709gl.html>.

[32]See Juzgado Nacional de Primera Instancia en lo Comercial No. 10, 56.179 (October 10, 1994), 1 UNILEX D.1994-24.2; Juzgado National de Primera Instancia en lo Comercial No. 7, 50272, (May 2, 1991), 1 UNILEX D.1991-4.

[33]See Internationales Schiedsgericht der Bundeskammer der gewerblichen Wirtschaft–Wien, SCH-4318 (June 6, 1994), 1 UNILEX D.1994-13; Internationales Schiedsgericht der Bundeskammer der gewerblichen Wirtschaft–Wien, SCH-4366, (June 15, 1994), 1 UNILEX D.1994-14. Both arbitral awards measure full compensation by prime interest rate or average prime interest rates, and these are these are verifiable indices. So arguably the language of the award merely is inconsistent with the remedy given. But both tribunals explain that the measure is used in the case of merchants, thereby suggesting that other measures of full compensation would be used in other cases. The reasoning of the awards ("full compensation") allows the calculation of interest based on unverifiable measures.

implemented poorly.

III. Inferences About Predominant Party Preference

The case for incorporation relies on estimates of specification, error and administrative costs. Direct survey or experimental evidence of the size and direction of these costs does not exist, and measurement of these costs under different interpretive and default regimes would be difficult. Thus, the evidence supporting these estimates must be indirect, based on inferences from other data. A datum consistent with incorporation is the pattern of predominant contracting behavior: parties contracting under incorporation regimes appear not to contract out of them with regularity. Although factors other than a preference for incorporation could explain this pattern (e.g., asymmetrical information, cognitive bias), the pattern is consistent with the preferences of most contracting parties in most contracts controlled by incorporation regimes. Correspondingly, the evidence against incorporation must be indirect too. An inference that most contracting parties do not prefer incorporation has been drawn from three different features of observed contracting behavior. The inference from each of these features is unsound.

A. Opting out of Specific Incorporation Defaults

Contracting parties sometimes opt out of particular default rules set by incorporation. For instance, some contracts disclaim implied warranties of quality, disclaim or limit consequential damages, or both. Contracts for the sale of goods also sometimes substitute repair-or-replacement remedies for damages, thereby at once displacing both default measures of damages and the right to reject nonconforming goods. These default rules are not among the few bright line default rules set by formalism, since their application turns on information that

can be provided to the court reliably only by the contracting parties.[34] Because parties opt out of particular defaults set by incorporation, it is inferred that parties typically prefer non-incorporation regimes.[35]

The inference is unsound. Contracts which displace particular default provisions may be unrepresentative of typical contracts. For instance, an exclusive remedy of repair-or-replacement limits the seller's potential liability to the cost of repair or replacement, thereby liquidating its maximum expected liability for breach. This amount can be below its expected liability set by default damage measures. Repair-or-replacement works to allocate to the buyer loss from the seller's breach exceeding that amount. If the buyer has the superior ability to reduce or eliminate the excess loss, the remedy yields a lower total expected cost from breach than default remedies. But for sellers who cannot make cost-effective repair or replacement or buyers who are not in a superior position to take precautions, default remedies are preferable. An early non-random sample of warranties offered by manufacturers shows that

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[34]See Schwartz, note 6, at 280.

[35]See Scott, supra note 1, at 379; Robert E. Scott, The Rise and Fall of Article 2, 62 Louisiana L. Rev. 1009, 1059-1060 (2002); cf. Schwartz & Scott, supra note 1, at 603-604.

warranties and damages frequently are not disclaimed.[36] A generalization to the population of contracts from observations of select contracts or contractual provisions therefore is unsafe.

[36]See George L. Priest, A Theory of the Consumer Product Warranty, 90 Yale L. J. 1297, 1345 (1981).

A more serious problem with the inference is its basis: the fact that parties contract around particular default provisions of specific incorporation regimes. Because incorporation regimes can adopt different default rules, the inferiority of particular defaults in fact adopted does not condemn the incorporation strategy. It simply shows that the regimes should adopt different particular defaults. (Some incorporation regimes in fact have set particular defaults in the way the inference takes typical parties to prefer.[37]) The safe inference from the preference of typical parties for particular terms is not they do not prefer incorporation. It is merely that they prefer different terms than are set by default rules under specific incorporation regimes.

Finally, the inference on its own terms fails to show that parties do not prefer incorporation. This is because contracting out of particular default provisions evidences nothing about the defaults parties leave undisturbed. There is no evidence that parties typically opt out of interpretive and default rules that include business norms. The instances in which opting out is observed usually involve damages remedies,[38] not typically business norms as part of merger clauses, for instance. Thus, the contracting behavior of parties for particular provisions shows nothing about their preferences for or against incorporation.

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[37]See, e.g., U.C.C. § 5-111(a) (letter of credit issuer not liable to its beneficiary for consequential damages resulting from the issuer's breach); Uniform Computer Information Transactions Act § 807(b)(1) (2002) (licensor not liable for consequential damages resulting from breach in connection with published informational content provided); CISG art. 49(1)(a), 64(1)(a) (right to avoid contract upon fundamental breach).

[38]See supra note 33.

B. Opting into Inexpert Arbitration

Contracts sometimes contain a choice of forum clause calling for arbitration. The parties or rules of the arbitral institutions selected in turn often appoint arbitrators not knowledgeable with the subject matter of the dispute. They instead are chosen for their neutrality and familiarity with arbitration. This is particular true with international commercial arbitration.[39] A rejection of incorporation has been inferred from the choice of inexpert arbitration: "Many contracting parties have voted with their feet. Some classes of contractors have exited the state system entirely... The upshot is a new contract law [i.e., one dependant on highly contextual sorts of interpretation] that is irrelevant to many (if not most) contracting parties."[40] The choice of arbitration, however, does not support the inference. An arbitration clause in a contract selects only a forum, not applicable law. The law applicable to the contract therefore can continue to incorporate business norms: context-dependent law can remain "relevant" to it. Selection of an arbitral forum even allows parties to choose terms that displace mandatory terms.[41] This enhanced choice of terms, where possible, can include business norms that mandatory terms otherwise might displace. Further, the rules of a number of international arbitral institutions provide for the application of trade usage and do not exclude

[39]See Yves Dezalay & Bryant G. Garth, Dealing in Virtue: International Commercial Arbitration and the Construction of the Transnational Legal Order 36-37, 50 (1996). For the bearing of a nonjudicial adjudicator as an "expert" or an "arbitrator" on enforcement of an arbitral award, see William W. Park, The Relative Reliability of Arbitration Agreements and Court Selection Clauses, in International Dispute Resolution 3, 21-22 (J. Goldsmith ed. 1997).

[40]Scott, supra note 1, at 379 (footnote omitted); see also Scott, supra note 34, at 1060.

[41]See Stephen J. Ware, Default From Mandatory Rules: Privatization of Law Through Arbitration, 83 Minn. L. Rev. 703 (1999); cf. Charles N. Brower & Abby Cohen Smutny, Arbitration Agreements Versus Forum Selection Clauses: Legal and Practical Considerations, in International Dispute Resolution, supra note 37, at 37, 45-56.

reliance on other sorts of business norms.[42] For both reasons, a preference for arbitration does not show a rejection of incorporation. At most it shows merely a preference for nonjudicial forms of adjudication.

C. Opting into Expert Arbitration: Trade Associations

[42]See Christopher R. Drahozai, Commercial Norms, Commercial Codes, and International Commercial Arbitration, 33 Vander. J. Trans. L. 79, 110, 113, 130-131 (2000).

Parties in specific industries choose to have their contracts governed by formalist regimes. The inference that contracting parties typically prefer formalism over incorporation is based on case studies of arbitration in several trade associations. These associations contract out of Article 2 of the UCC and create a formalist system of arbitration. The systems created by the National Grain and Feed Association (NCFA) and the trade associations of cotton merchants and millers ("cotton associations") share important features.[43] The rules of both associations consist of mostly precise, bright line rules and definitions, not business norms such as trade usage and the like. Arbitral rules or practice in both trade associations prohibit arbitrators from taking into account custom when inconsistent with the express terms of the contract. In general, arbitrators seldom rely on business norms to interpret and supply terms for industry contracts. Arbitrators in both trade associations have industry-specific expertise. These systems of

[43]See Lisa Bernstein, Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions, 99 Mich. L. Rev. 1724 (2001) [hereinafter "Private Commercial Law"]; Lisa Bernstein, Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms, 144 U. Pa. L. Rev. 1765 (1996) [hereinafter "Merchant Law"].

arbitration among members of the NCFA and the cotton association are taken to suggest that contracting parties typically prefer formalist to incorporation regimes.[44]

[44]See Bernstein, Merchant Rules, supra note 43, at 1766; Bernstein, Private Commercial Law, supra note 43, at 1788; Lisa Bernstein, The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study 66 U. Chi. L. Rev. 710 (1999).

The inference to the preferences of typical contracting parties is unjustified because the implicit generalization upon which it based is unsound. These case studies suffer from a problem of external validity: the population of contracting parties do not share characteristics of the parties and contracting environment of members of the NCFA and cotton associations. NCFA and cotton association members enter into standardized contracts whose terms are defined by mostly precise and regularly updated industry rules. A series of small-profit contracts frequently are entered into between members, and their reputation for performance or breach is communicated to actual or potential financiers and other industry members. All actual and potential contracting parties must be members of the industry associations. Finally, the arbitrators have expertise in the trade association rules and the underlying transactions. These characteristics bear on the likely specification and adjudicatory error costs observed associated with contracts governed by the NCFA and the cotton association.[45]

The contracting environment reflects conditions under which nonlegal sanctions reliably substitute for enforcement: the presence of repeat transactions, a low discount rate from

[45]The description in the text summarizes features described in Bernstein, Merchant Rules, supra note 43; and Bernstein, Private Commercial Law, supra note 43.

breach of a discrete contract, and a low cost to others of learning of the quality of performance. Trade association members enter into repeat transactions with each other; the profit from each contract is small; and the reputation of members for performance easily discovered. Under these conditions, breach and therefore litigation predictably is infrequent.[46] Because the prospect of litigation is remote, the expected cost of adjudicatory error for members of the trade associations is low. Specification costs for members are low too, because their contracts are standardized and already fairly completely specified by trade association rules. The arbitrators' industry-specific knowledge makes the rate of adjudicatory error low. Although arbitral expertise could reduce adjudicatory error even further if arbitrators adverted to business norms in the industry,[47] the small profit margin on the members' contracts makes it likely that the marginal benefit to the parties of a further reduction in error is very low. In these circumstances formalism appears to have both lower adjudicatory error and specification costs than incorporation. The conclusion is consistent with the preference of trade association members for formalism.

The population of contracting parties and contracts does not share the features of contracts entered into by members of trade associations. The preferences of typical contracting parties are heterogenous, reflected in the range of different terms in contracts. This is unlike the uniform demands of contractors in the NCFA and the cotton associations. Unlike the contracts entered into by trade association members, the variety of typical contracts do not take standardized terms. The sophistication, abilities of contracting parties and transactions are too

[46]As confirmed by Bernstein, Private Commercial Law, supra note 43, at 1762.

[47]Cf. Avinash K. Dixit, Lawlessness and Economics 26-27 (2004).

diverse to generate a compact and frequent set of terms. Typical contracts also are not entered into against a background of constant updating of definitions of terms and applicable industry or transaction-specific rules. Further, the range of typical contracts are discrete, not part of repeat transactions or long-term contracts. They are often entered into between strangers in circumstances in which reputational bonds are not strong. Typical contracts therefore do not reliably occur under conditions in which soft law operates. Finally, these contracts are adjudicated by judges or inexpert arbitrators, not arbitrators with industry-specific knowledge. Taken together, the differences between typical contracts and contracts among trade association members make the latter special. They are not representative of the domain of contracts to which contract law.

Incorporation arguably optimally minimizes contracting costs for typical contracting parties. The application of business norms to the bargain saves parties significant specification costs when transaction-specific terms and default rules are unavailable. Incorporation increases adjudicatory error costs when inexpert adjudicators take account of these norms in interpreting terms and setting default rules. The reduction in specification costs arguably exceed the increase in these error costs. Even if Article 2 of the UCC and the CISG do not best implement the incorporation strategy, they implement the strategy appropriate for the domain of contract law.

IV. Evaluating Arguments for Choice of Regime

The case for incorporation is incomplete in two respects. Its estimates of specification, error and administrative costs are based only on limited indirect evidence. At crucial points the estimates rely on empirical hunches. The case also ignores other variables that affect the size of contracting costs incurred under a interpretive and default regime. For example, the total

cost of performance and renegotiation are assumed to be invariant between formalism and incorporation. Obviously, the assumption of invariance may be unrealistic because incorporation, for instance, can affect these costs in different directions: increasing the need to monitor performance or litigate to assure that contract terms are not altered by ongoing performance, while reducing renegotiation costs by interpreting contract terms according to business norms that take into account changed conditions of performance. For its part, defenses are formalism are incomplete too; they ignore or assume that specification and renegotiation costs are low.[48]

The debate over incorporation is inconclusive because it does not establish a complete and compelling argument for or against the strategy. But a defensible basis for recommending an interpretive and default regime sets a less demanding standard, and the incorporation strategy arguably satisfies it. Conclusiveness is not an appropriate standard by which to test normative proposals for the design of legal rules.

[48]See, e.g., Bernstein, Private Commercial Law, supra note 43, at 1741-1742.

To see this, first note that the debate over incorporation is not inconclusive in the way debate over the choice of remedy is inconclusive. In particular, the extent to which the choice of remedy is inconclusive or indeterminate is greater than the choice of interpretive and default regime. The literature in the former debate suggests that none of the traditional remedies for breach is likely to be efficient when all relevant variables are taken into account. The efficient remedy, considering all these variables, will award neither expectation damages, reliance damages, nor specific relief. Instead, it is likely to involve some adjustment of these remedies–say, X percent of expectation damages.[49] Because there are an indefinitely large number of nontraditional remedies, any one of which may be efficient, the indeterminacy in the choice of efficient remedy is large. There is much less inconclusiveness or indeterminacy in the debate over incorporation. This is because the debate describes jointly exhaustive possibilities: even taking into all relevant variables, an efficient regime will be either formalist or incorporationist or some other version of contextualism. There are no other possibilities. Unlike the choice among traditional recognized remedies, the incorporation debate is not inconclusive in the sense that none of the three possible regimes may be efficient. The question simply is which among this small set is likely be an efficient interpretive and default regime.

Notice next that the debate focuses on a few variables affecting the value of a contract: specification costs, adjudicatory error costs, and administrative costs. Formalism and

[49]Cf. Craswell, Against Fuller and Perdue, supra note 5, at 111.

incorporation disagree about their likely values over the range of contracts regulated by contract law. The disagreement is not principally over other variables that might affect contract value. Nor is it over the normative criterion of efficiency by interpretive and default regimes should be evaluated. Thus, the debate turns only on the estimates needed to identify an efficient regime among a few possible candidates, taking into account select variables. Clearly, the evidence for the estimates of the values of these variables is incomplete and indirect. The issue therefore is whether an incompleteness in analysis or evidence for the estimates undermines a proposal for interpreting terms and supplying default rules.

This requires determining the appropriate standard for selecting among strategies for legal design. Formalism and incorporation recommend different strategies for the design of legal rules. They are normative proposals, not explanations of existing interpretive and default regimes, and their implementation. Because the relevant analysis and evidence for selecting a strategy is incomplete, the incompleteness of a case for a strategy undermines it only if conclusiveness is the appropriate standard for selecting a regime. Conclusiveness is a demanding normative standard. It requires that a recommendation of a regime be supported by compelling evidence about all of the variables affecting the ex ante value of a contract. This is the standard sometimes implicit in the comparison of the incorporation debate to arguments over the choice of efficient remedy.[50] According to this standard, the choice of incorporation or

[50]See, e.g., Katz, The Economics of Form, supra note 7, at 524. Posner uses a comparably strong standard in evaluating explanations and contract law doctrine and recommendations for their reform; see Eric A. Posner, Economic Analysis of Contract Law After Three Decades: Success or Failure?, 112 Yale L. J. 829 (2003).

formalism is inconclusive because supported by only partial analyses of specification, error and administrative costs. The conclusion sometimes drawn, based on the standard, is that a case for a propose regime is unpersuasive.

Posner's argument is not directed at the choice between incorporation and formalism.

But the conclusiveness standard at work is inappropriately strong. It disqualifies proposals that are not backed by evidence of their precise impact on all relevant variables in all settings. In general, few proposals or explanations satisfy this strong demand. As a descriptive matter, recommendations frequently are justified by estimates based on incomplete information. For instance, the common law theft rule can be justified by relatively untutored empirical judgments about the comparative burden of monitoring to owners and precautions to purchasers of goods. The absence of precise estimates of these factors or consideration of the impact on the market price of goods, does not undermine the common law theft rule. Nor does the inability to impugn the different estimates about the same variables implicit in the civil law theft rule. Similarly, legislative proposals backed by empirical studies often do not satisfy this strong demand.[51] The normative point to be drawn from these examples is that conclusiveness is not a requirement for finding a proposal for legal design persuasive.

[51]See, e.g, William R. Shadish et al., Experimental and Quasi-Experimental Design for Generalized Causal Inference 84 (2002).

A more modest standard roughly requires that a recommendation identify salient variables affected by the choice and offer convincing evidence about their likely values. It requires more than a mere listing of relevant variables that could affect the choice of legal regime.[52] The standard therefore is not so weak that it excludes few proposals. To be adequate, a proposal must suggest that, given the evidence and identified variables, it is superior to competing available proposals. Under this more modest standard, a proposal still may be flawed because backed by evidence that is no more persuasive than offered by competing proposals. However, the standard does not require that the values of all potentially relevant variables be estimated, or that the evidence for salient variables identified be completely convincing. For instance, it does not require support by randomized studies or comparisons among studies. It allows an inconclusive case for a proposal to be persuasive. The case for incorporation outlined in Part II relies on empirical judgments and indirect evidence for its estimates of specification, enforcement and administrative costs. Given its nature, the case is tentative and the debate over strategy inconclusive. This does make not the case for incorporation unpersuasive.

Conclusion

The traditional debate over the incorporation strategy focused on freedom of contract.[53]

[52]Cf. Richard Craswell, In That Case, What Is the Question? Economics and the Demands of Contract Theory, 112 Yale L. J. 903, 913 (2003); Katz, The Economics of Form, supra note 7, at 525 (both suggesting that choice of rule be informed by a list of relevant variables).

[53]For an early instance of this focus in the incorporation debate in letter of credit law, see Dana Backus & Henry Harfield, Custom and Letters of Credit: The Dixon, Irmaos Case, 52 Colum. L. Rev. 589 (1952); Honnold, supra note 15.

Freedom of contract or other moral concerns are irrelevant to the choice of strategy. Interpretive and default regimes do not interfere with a contracting party's freedom to select terms or opt out of default rules. Even if they do, all regimes affect parties differently, facilitating enforcement of terms preferred by some parties and making more costly the enforcement of terms preferred by other parties. The selection of a strategy therefore be based on factors other than freedom of contract or other moral concerns.

The contemporary debate over incorporation assumes that interpretive and default regimes should maximize ex ante contract value.[54] It focuses on the likely effect of a regime on the size of specification costs incurred in contracting, and the adjudicatory error and administrative costs incurred in enforcing the contract. Earlier legal literature often dismissed formalism by questioning the notion of literal or "plain" meaning. This is a mistake: the operative notion of meaning is coherent,[55] and formalism is a plausible strategy. If formalism is a poor interpretive and default regime, it fails because it does not optimally reduce total contracting costs. The contemporary debate over the choice of regime is inconclusive in two respects: it does not take into account the full range of variables potentially affecting contract value and lacks completely convincing evidence for estimates of the select variables it considers.

Conclusiveness or completeness, however, is the wrong standard by which to assess proposals for rule design. The incorporation debate instead is properly assessed by a more modest standard of persuasiveness. Even if the tentative case for incorporation fails, it does so

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[54]See Alan Schwartz, Karl Llewellyn and the Origins of Contract Theory, in The Jurisprudential Foundations of Corporate and Commercial Law 12, 20-21 (J. Kraus & S. Walt eds. 2000); Eric A. Posner, The Decline of Formalism in Contract Law 61, 70 (F.H. Buckley ed. 1999).

[55]See supra note 1.

because it is unconvincing, not because the case is incomplete.