The Forthright Negotiator Principle and the Legitimate Role of Ambiguity in Contracts

by

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When drafting a contract, it's always best to minimize ambiguity, right? As with so much in the law, the answer, it turns out, is a clear "it depends." Common sense suggests that clarity should be a primary goal in drafting contracts. But as Judge Posner notes, ambiguity may play a valuable role in contract drafting.[1] As he explains in The Law and Economics of Contract Interpretation, an economic analysis of contract interpretation reveals that the presence of intentional ambiguities in contracts is not only rational but, in many circumstances, desirable. There has been much recent discussion of the so-called forthright negotiator principle. Some of it seems to misapprehend the principle, suggesting it gives rise to an affirmative duty to eliminate ambiguity. It does not. It is simply one of a number of principles of contract interpretation used by, among others, the Delaware courts. An economic analysis of the forthright negotiator principle shows that it aids social efficiency. Posner places the principle in its proper context.

The Law and Economics of Contract Interpretation

Posner begins with the premise that the "object of judicial enforcement of contracts is to minimize" the social transaction costs associated with contracts.[2] Such costs are a function of the parties' expenditures in the contract-drafting stage, as well as the expected costs of litigation or other dispute resolution. Posner suggests that greater expenditures on the former typically correlate with lower probability, and cost, of litigation.[3] Presumably, this correlation is at least to some extent a function of reduced ambiguity.[4] When viewed from this cost-benefit perspective, it becomes apparent that it is *not* socially desirable to draft contracts free from any possible ambiguity (indeed, it may be impossible to draft contracts free from *any* possible ambiguity). Rather, parties should not expend more resources to negotiate and draft a contract than their expected savings from potential litigation costs in the future.

While courts cannot control many of the variables in Posner's equation for social transaction costs, they have adopted rules of construction that help minimize social costs in three ways. First, courts can minimize costs by following a hierarchy of rules that limits judicial inquiry. Second, courts can minimize costs through consistent application of clear rules of

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[1] See Richard A. Posner, The Law and Economics of Contract Interpretation, 83 Tex. L. Rev. 1581, 1583 (2005) ("Deliberate ambiguity may be a necessary condition of making the contract; the parties may be unable to agree on certain points yet be content to take their chances on being able to resolve them, with or without judicial intervention, should the need arise.").
[2] Id. at 1584.
[3] Id. at 1608.
[4] See id. at 1584.

construction, giving rise to expectations on which parties may rely. Third, courts can minimize costs by allocating burdens (e.g., of proof) to the "cheapest cost avoider."[5]

Delaware Rules of Contract Construction

One of the most well-known rules of contract construction is the "clear meaning rule" or the "four corners rule."[6] It provides that "where the parties have created an unambiguous integrated written statement of their contract, the language of that contract (not as subjectively understood by either party but) as understood by a hypothetical reasonable third party will control."[7] This rule encourages social efficiency in two ways. First, because the clear meaning of the contract dictates its interpretation, extrinsic evidence is not admissible to interpret it.[8] By limiting the scope of judicial inquiry to the language of the document, the costs to the judiciary and the parties in litigation are reduced. Second, because contracting parties recognize that courts utilize the clear meaning rule, they need only expend resources clarifying their contractual intent to the extent they feel possible unforeseen circumstances are worth addressing.

Another well-known rule of contract construction is the parol evidence rule. It provides that extrinsic evidence contradicting or supplementing a completely integrated contract is not admissible.[9] However, where the agreement is not integrated, and "there is uncertainty in the meaning and application of the terms of the contract, [courts] will consider testimony pertaining to antecedent agreements, communications and other factors which bear on the proper interpretation of the contract."[10] Thus, parties may make a conscious decision when drafting a contract to include an integration clause, thereby limiting the role of extrinsic evidence in any future disputes, as well as limiting the costs of such potential litigation.[11]

The forthright negotiator principle is yet another principle of contract interpretation utilized by the Delaware courts. It comes into play where resort to the parol evidence rule leaves proper construction uncertain. "[W]here ambiguity in contract language is not easily resolvable by extrinsic evidence, it may be necessary for the court, in considering alternative reasonable interpretations of contract language, to resort to evidence of what one side in fact believed the obligation to be, coupled with evidence that the other party knew or should have known of such

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[5] See id. at 1601 (discussing the allocation of transaction costs to the "cheapest cost avoider").
[6] U.S. West, Inc. v. Time Warner, Inc., C.A. No. 14555, 1996 Del. Ch. LEXIS 55, at *30 (Del. Ch. June 6, 1996); Posner, supra note 1, at 1596.
[7] U.S. West, 1996 Del. Ch. LEXIS 55, at *29-*30.
[8] See Eagle Indus., Inc. v. DeVilbiss Health Care, Inc., 702 A.2d 1228, 1232 (Del. 1997) ("If a contract is unambiguous, extrinsic evidence may not be used to interpret the intent of the parties, to vary the terms of the contract or to create an ambiguity.").
[9] See Peden v. Gray, No. 188, 2005, 2005 Del. LEXIS 389, at *6 (Del. Oct. 14, 2005).
[10] Pellaton v. Bank of New York, 592 A.2d 473, 478 (Del. 1991).
[11] See Posner, supra note 1, at 1603 ("So just as the parties choose whether to have a written contract and whether to include an arbitration clause, they also choose whether to state that their contract is integrated and by so doing to limit further the role of the jury or judge as the trier of fact and the expense of litigating a suit should their contractual relationship break down.").

belief."[12] Applying the forthright negotiator principle in such a case, the court would adopt the meaning as understood by one side, but known to both parties.[13]

Application of the forthright negotiator principle furthers the goal of minimizing social transaction costs. If Party A knows that Party B believes a contract to mean one thing, but Party A believes it to mean another, Party A can resolve this ambiguity at the lowest cost *ex ante*. Party A need only disclose the ambiguity, while Party B would need to invest resources to even learn that an ambiguity exists. By adopting the forthright negotiator principle, the courts have essentially placed a burden on the lowest cost avoider to disclose a known ambiguity *ex ante* or, alternatively, be forced to accept the other party's interpretation *ex post* should the issue be litigated.

To some observers, it seems Party A has behaved poorly, even actionably so. From this view, it is but a short step to recast the forthright negotiator principle as an affirmative duty, owed by one negotiator to another. It is not. While there are any number of arguments concluding that Party A should (or shouldn't) disabuse Party B of his blissfully clarion view of an ambiguous provision, the forthright negotiator principle is not one of them. Rather, it is simply a rule of construction.

[12] U.S. West, 1996 Del. Ch. LEXIS 55, at *34-*35.
[13] Id. at *63-*64.