

CHAPTER EIGHT

INTERPRETATION OF CONTRACTS

8.1 Introduction

After parties make an agreement, they may have a dispute about what the agreement means. So even if there is an enforceable contract that meets all the formation requirements discussed in Chapters 2-7, there may still be disputes about what rights and duties the contract creates. Of course, it may sometimes be necessary to resolve such disputes in order to determine whether an agreement is enforceable or not. These disputes generally occur where the meaning of some part of the contract is not clear, although there are a few special situations where courts may supply or sever contract terms even where what the contract states is clear.

Parties often ask courts to resolve such disputes by interpreting the contract. This requires the court to actually decide the meaning of the disputed part, or “term.” This text will use the word “term” to describe any particular part of the contract whose meaning is disputed by the parties--whether that part is one word long or 100 words long. For example, parties to a sale of goods contract may dispute the meaning of the “delivery term”--a term which may be described in a clause 50 words long. In this text, the “delivery term” means that entire 50-word clause.

Courts interpret agreements when the parties ask them to do so. Sometimes courts must interpret contracts to determine if they are enforceable at all. More often, courts must decide the meaning of enforceable contracts, in order to resolve disputes between the parties. Section 8.2 discusses this.

Because the power to interpret a contract is a great power, free market jurisdictions carefully guide and limit it. Section 8.3 discusses some of the most important of these “guides and limits.” Specifically, it explains ten general rules of interpretation that many courts follow in deciding what agreements mean:

- (1) courts try to interpret contracts so that they are valid and reasonable, but courts cannot simply interpret contracts any way they wish (Section 8.3a);

- (2) many jurisdictions say interpretation should be subjective--based on the actual intentions of the parties--but if that is not possible, then it should be objective--based on what reasonable people generally intend in similar situations (Section 8.3b);
 - (3) courts consider the whole contract (Section 8.3c);
 - (4) courts try to avoid inconsistency between terms (Section 8.3d);
 - (5) when terms in a contract conflict, courts value certain types of terms more highly than other types of terms (Section 8.3e);
 - (6) courts consider the ordinary meaning that a reasonable person in the parties' situation would understand a disputed term to have (Section 8.3f);
 - (7) courts consider the main purposes of the parties when they made the contract (Section 8.3g);
 - (8) courts consider all the surrounding circumstances, particularly the course of performance, prior dealings between the parties, and trade usages (Section 8.3h);
 - (9) disputed terms are interpreted against the party who drafted the contract, if that is reasonable in the circumstances (Section 8.3i);
- and (10) courts in many jurisdictions interpret contracts to contain specific terms that the law requires or allows, if the parties omitted those terms (Section 8.3j).

Courts use various types of evidence to help them decide the meaning of agreements. In general, this can include documents, testimony from the parties or other witnesses, and reference materials. However, the common law “parol evidence rule” limits the use of certain types of evidence. This rule basically says that where a final writing contains contract terms of the parties, a court cannot generally allow evidence of statements made by the parties prior to that writing to contradict or add to the terms of a complete writing, or contradict the terms of an incomplete writing. The types of evidence courts may use to resolve interpretation disputes are discussed in Section 8.4.

Finally, Section 8.5 explains what happens if courts cannot interpret a disputed part of an agreement. When a material term cannot be interpreted, the agreement is probably unenforceable, since it is probably not definite and reasonably clear. But when an immaterial term cannot be interpreted, the agreement may be enforceable without that term, if the court can sever the term.

***** WHY IS THIS IMPORTANT?** Why is the interpretation of contracts such an important power in free market jurisdictions?

The ability of courts to interpret contracts is important for several reasons. One reason is that sometimes parties need the court to tell them what their contracts say! The basic purpose of interpreting a contract is to determine what rights and duties the parties created when they made their contract. Once courts interpret a contract, they know whether to enforce it and how to enforce it. But if there were no fair and efficient methods to interpret contracts, then parties would not be able to rely on their own contracts. In some cases, they would not even be able to understand their own contracts. A court's interpretation of a disputed contract term can also be a helpful guide for the parties to follow in the future.

Another reason contract interpretation is important is that it often helps to resolve or even prevent disputes. A party usually asks a court to help interpret her contract only when she thinks that another party to the contract has violated or will violate the contract. So by providing fair interpretations, courts give parties a way to end or avoid conflict related to their contracts.

*** **ADDITIONAL REFERENCE:** Chapter 1 ("Basic Aspects of Contract Law"), Section 1.4g contains a more concise discussion of the interpretation of contracts.

8.2 Courts Interpret Contracts When the Parties Ask Them to Do So

Courts interpret all kinds of contracts, from small implied contracts to complex, carefully drafted contracts creating international joint ventures. But even where contracts are written, or prepared by lawyers, there are often disputes between the parties about the meaning of the contracts.

When parties bring such disputes to court, the court tries to help them resolve the dispute, by providing a fair and appropriate interpretation. But the court has no power to act in such disputes unless at least one of the parties asks it to do so. And of course, courts do not bother interpreting contract terms when the parties agree about what they mean! Courts do not have time to waste. In general, courts resolve the issues that are actually in dispute between the parties to a contract, and nothing else.

In particular, courts may need to use rules of interpretation to decide:

- (1) if there is an enforceable contract; and/or
- (2) what an enforceable contract means.

These two issues are briefly discussed below.

A court may have to interpret disputed parts of an agreement simply to determine whether the agreement is enforceable. As explained in earlier Chapters, courts generally will not enforce agreements that are void, or voidable where a party has avoided them. And if a court decides that

a disputed part of an agreement makes the whole agreement unenforceable, the court will stop, and of course will not enforce the agreement. An example would be if a potentially illegal part of an agreement was not clear. If a court interpreted the unclear provision to be illegal, it could not be enforced. Of course, sometimes an unenforceable part of an agreement can be severed or reformed. In that situation, a court would proceed to enforce the contract that remained.

If there is an enforceable contract, but the parties do not agree about what it means, then the court must interpret the contract in order to find out how to enforce it. Usually, when a dispute about interpretation comes to court, at least one party is arguing that the other party failed to perform according to the contract. The other party is likely to argue that she did perform properly, based on what she thinks the contract means. Obviously, a court cannot decide fairly whether a party has properly performed a contract unless the court is sure what the contract required the party to do. Likewise, a court cannot order a fair and appropriate remedy unless it knows exactly how a party's performance differed from what the contract required. So interpretation can be a crucial step in the process of contract enforcement. Performance will be discussed in detail in Chapter 9 ("Performance and Discharge of Duties"), and remedies will be discussed in Chapter 10 ("Remedies").

***** ADDITIONAL REFERENCE:** Chapter 5 ("Legality"), Section 5.5b, and Chapter 7 ("Other Contract Formation Problems"), Section 7.7c discuss severance of contract terms; Chapter 9 ("Performance and Discharge of Duties") contains further discussion of contract performance; and Chapter 10 ("Remedies") contains further discussion of remedies courts may order, including severance in Section 10.7c.

8.3 Some Basic Rules Courts Use to Interpret Contracts

Interpreting contracts can be easy or difficult, depending on how the parties made the agreement. For example, when parties put their contract in writing and use clear words, it may be fairly easy to determine what each party was supposed to do. But when parties make a contract that is not so clear, it can be difficult to determine the terms of their agreement.

Free market jurisdictions have developed rules of interpretation to help courts resolve disputes about the meaning of contracts in a fair, reliable way. Although the rules may vary in different jurisdictions, many jurisdictions apply some of the same basic rules. Depending on the circumstances in a case, a court may use one or more of the rules of interpretation discussed in the following Sections to resolve disputes between parties about the meaning of a contract. In fact, courts use as many rules as they need to resolve such disputes, unless that would violate one of the rules themselves. Of course,

there are rules of interpretation that are not discussed in this text. The rules below are only some of the more important ones.

Before discussing these basic rules, it is important to stress again the basic principle that courts cannot generally get involved in a contract dispute unless a party involved in the dispute formally asks the court to help. The court cannot decide by itself to interfere.

8.3a **Rule Number One: Courts Try to Interpret Contracts So That They Are Valid and Reasonable, but Courts Cannot Simply Interpret Contracts Any Way They Wish**

Courts try to interpret agreements so that they are valid and reasonable contracts, if possible. For example, if an employment contract required an employee to work “full time,” a court would probably interpret that term to comply with any statutory requirements about the maximum number of hours such an employee was permitted to work. And if a cyclo driver agreed to take a passenger to Old Market for 500 riels, courts would probably interpret Old Market to mean the one in the area where the parties were--not one hundreds of kilometers away.

However, an important limit on courts’ interpretation power is that a court must base its interpretation on the contract itself. This key principle means that a court generally can enforce only the agreement that the parties made--not what one party later wants, and not something that the court thinks is better. There are a few limited exceptions, such as situations where courts may reform or sever agreements, or supply certain terms, as discussed in Sections 8.3 and 8.5 below. But in general, courts can enforce only what the parties agreed. This is true even if the result is difficulty or loss to one or more of the parties.

Another result of the above limit is that courts cannot generally use their interpretation power to make an invalid contract valid. So if it is clear that an agreement is invalid for reasons such as lack of capacity or legality, courts cannot generally interpret the agreement so that it becomes valid. Of course, there are some limited situations where courts may enforce promises or impose contract obligations even though there is no valid agreement about those obligations, such as where promissory estoppel or quasi-contract apply. But if none of those special situations applies, courts have no power to create an enforceable agreement merely because they wish to do so.

***** WHY IS THIS IMPORTANT?** Why can’t courts interpret contracts any way they wish, and why will they generally enforce only agreements the parties made?

The main reason courts generally enforce only the agreements parties actually make is freedom of contract. Parties generally know what they want their agreements to say. But in order for parties to make agreements that

do what they want, the parties need to be confident that no one--not even a court--has unlimited power to interfere and impose different ideas. That would be counterproductive, and unfair to the parties. In fact, parties' confidence that courts will not do that is at the heart of business and economic activity all over the world. And the basis for that confidence is the freedom of contract, which even the courts must respect.

Another reason for this rule is that it would usually be very difficult, and often waste a court's time, for a court to create contracts for the parties. That is not generally the function of courts in free market jurisdictions.

***** ADDITIONAL REFERENCE:** Chapters 1-7 describe the major elements of enforceable contracts, and the few situations where courts enforce promises or impose contract obligations even though there is no valid agreement about those obligations.

8.3b Rule Number Two: If the Meaning of a Disputed Term Is Not Clear from the Contract, Many Jurisdictions Say the Interpretation of That Term Should Be Subjective, but If That Is Not Possible, Then It Should Be Objective

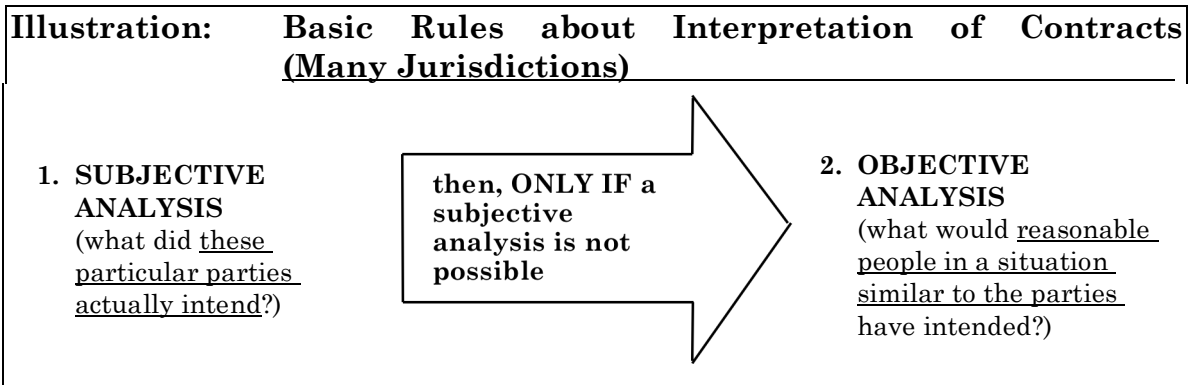
Many jurisdictions say interpretation of disputed terms should be subjective--based on the actual intentions of the parties--but if that is not possible, then it should be objective--based on what reasonable people generally intend in similar situations. This rule is difficult, but important. Of course, different jurisdictions have different rules in this area. So it is important to check the local law.

***** DEFINITION:** A **subjective interpretation** of an agreement is one based on what the parties themselves actually intended in their particular situation.

***** DEFINITION:** An **objective interpretation** of an agreement is one based on what reasonable people normally intend in situations similar to the situation of the parties.

Many societies have struggled with the question of how courts should interpret terms in contracts when the parties do not agree about the meaning: subjectively or objectively? For example, consider Case Study 31, the "what is chicken?" case. In that situation, courts might try to determine the meaning of "chicken" subjectively or objectively. The subjective analysis would ask what the parties actually meant when they used the word "chicken" in their contract, looking at things like what the parties now say they meant. The objective analysis would ask what reasonable people normally mean when they use the word "chicken" in situations similar to that of the parties, looking at things like accepted reference books.

Many jurisdictions appear to have decided on an approach to this problem which might be called a "subjective, then objective" approach. In these jurisdictions, when a court tries to interpret a disputed part of a contract, the court first looks at evidence of the subjective intentions of the parties. Then, only if the court cannot interpret the contract that way, the court performs an objective interpretation of the contract.



***** WHY IS THIS IMPORTANT?** Why do many jurisdictions use this "subjective, then objective" approach to the interpretation of contracts?

Under the "subjective, then objective" approach to contract interpretation, the actual intentions of the parties in making a contract are generally more important than the intentions of other people in similar situations. This is part of the freedom of contract: the law wants to help the parties enforce the contract rights and duties they want--not ones that someone else wants. So if the real intentions of the actual parties can be determined, then the court need not ask what some other "reasonable" people would have meant. The disadvantage of the subjective analysis is that it can be very hard to determine what the parties actually meant when they made the contract. So the results of this analysis might be uncertain or inaccurate. Even so, it appears that many courts start with the subjective analysis.

But if such courts cannot resolve an interpretation problem reliably using a subjective analysis, then they turn to an objective analysis. The objective analysis is not based on what the particular parties in the case actually intended. So in a way, the objective analysis is not as good a way to determine what a contract meant to the parties themselves. However, the objective analysis is often easier to perform. And it may be more efficient and certain. For example, it is easier to look in a dictionary for the reasonable, ordinary meaning of a disputed term than it is to try to decide whether parties are telling the truth about what they actually meant in their contract. And in practice, many--if not most--disputes about the meaning of contract terms must still be resolved using an objective analysis.

(1) An Example of the “Subjective, Then Objective” Approach

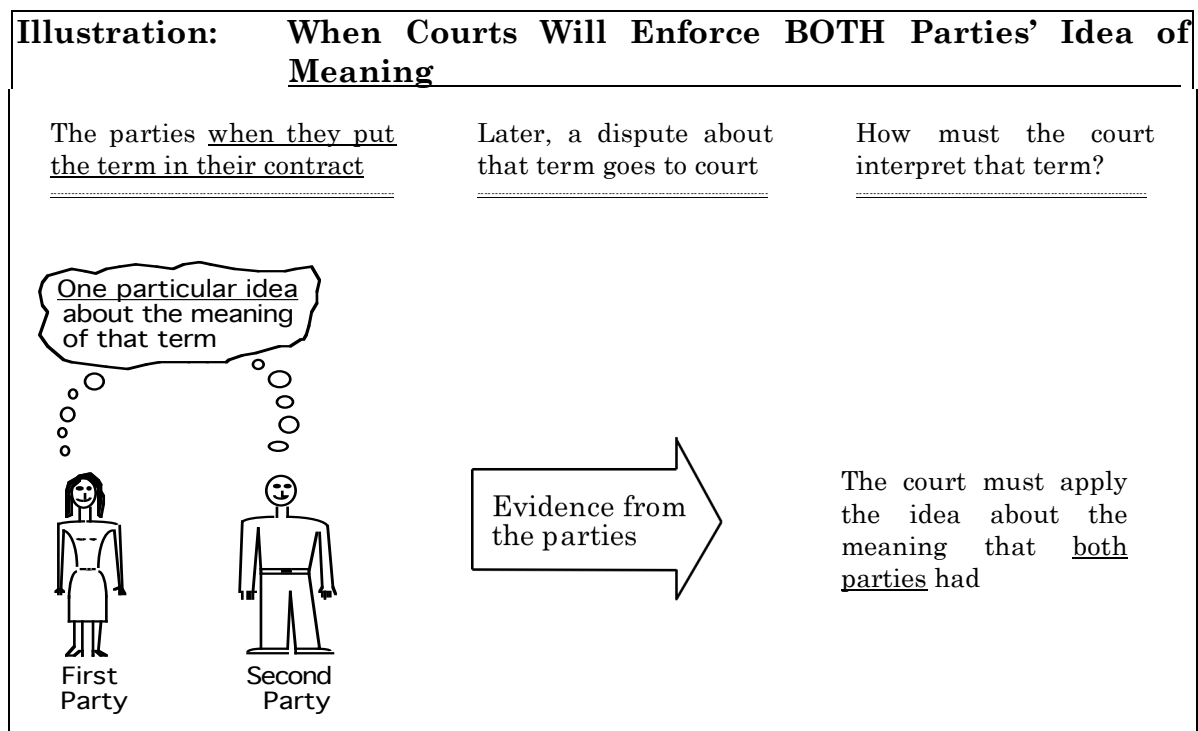
The “subjective, then objective” approach many courts use to interpret contracts can actually involve several specific steps. An example of this approach which is used in many jurisdictions in the United States is explained in three steps below. At each step, if the court can interpret the meaning of the disputed term, the court stops and does not proceed to further steps.

Step One -- If the evidence shows that the parties to the contract actually had the same understanding of the disputed term when they made their contract, then that is the meaning the court enforces. This is a subjective analysis, because it asks what the parties themselves actually intended the term to mean when they put it in their contract.

It appears that evidence of this intent would be found mostly in the testimony of the parties about what they meant. In practice, it is often difficult to find reliable evidence of this. That is because parties tend to say they had whatever intention will now help them by the time a dispute arrives in court. So often disputes cannot be resolved in this first step.

Common law courts might have this question resolved by a “jury.” A jury is basically a small group of ordinary citizens assembled to decide important questions of fact in some court cases. Civil law jurisdictions generally do not use juries.

The following chart shows how Step One in this analysis works.



If the evidence does not show that both parties had one particular idea about the meaning of the disputed term at the time they made their contract, then the court goes to the next step.

Step Two -- The second step in this process is more difficult. Under this step, if the evidence shows that, at the time of the contract:

- (1) the parties had different ideas about the meaning of a disputed term (subjectively);
- AND (2) (a) the second party knew the first party's idea but the first party did not know the second party's idea (subjectively); or
- (b) the second party should have known the first party's idea, but the first party had no reason to know the second party's idea (objectively);

then the first party's meaning is the meaning that the court must enforce.

As noted above, this Step requires a partly subjective, partly objective analysis of the evidence. The subjective analyses in parts (1) and (2)(a) above would appear to be based primarily on testimony of the parties about what they actually meant when they made the contract. If parts (1) and (2)(a) above are satisfied, there is no need to determine whether part (2)(b) is satisfied. However, because it is so difficult to find reliable evidence of the parties' subjective intentions, it is often necessary to go at least as far as part (2)(b) to resolve disputes about the meaning of disputed terms.

Part (2)(b) is an objective test. Basically, the test requires the court to ask whether the first party's meaning is reasonable and the second party's meaning is not reasonable. Specifically, if the first party had an idea about the meaning of a disputed term, and the second party had reason to know of the first party's idea--even though the first party had no reason to know of the second party's idea--then the court must interpret the term to mean what the first party thought it meant. Basically, the court tries to determine what reasonable people would have thought the disputed term meant if they had used it as the parties did. To do this analysis, courts use the rules of interpretation explained in the rest of this Chapter. In common law jurisdictions, the objective rules of interpretation explained in the rest of this Chapter are generally applied by courts, not juries.

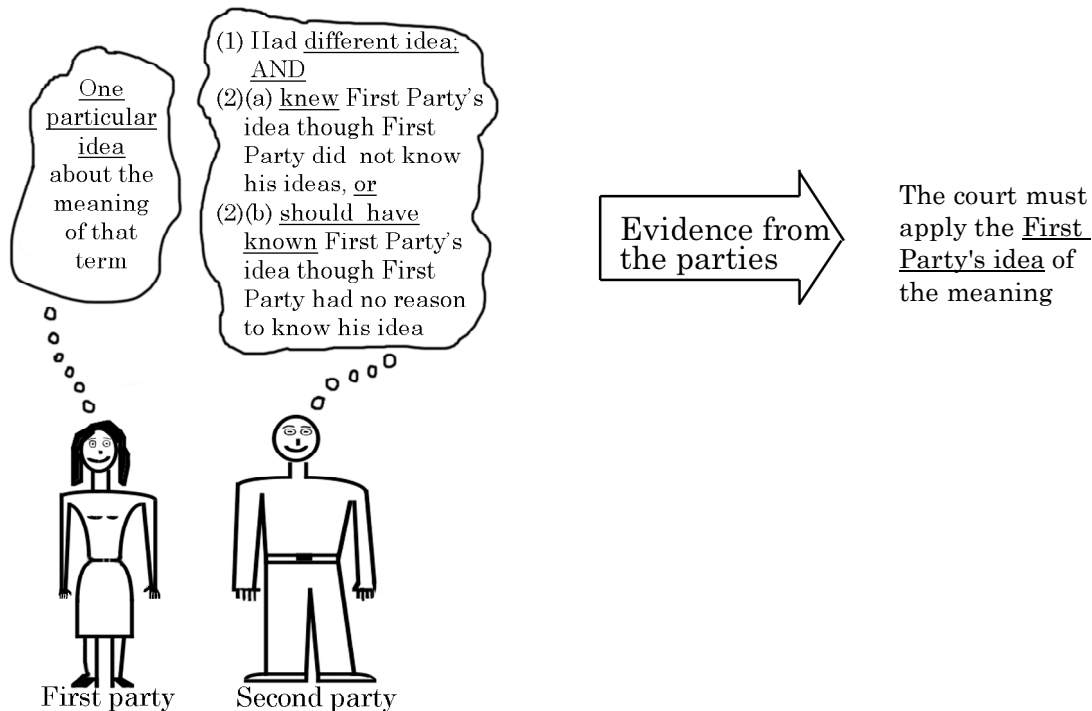


Illustration: When Courts Will Enforce ONE Party's Idea of Meaning

The parties when they put the term in their contract

Later, a dispute about that term goes to court

How must the court interpret that term?



If the evidence does not clearly show that the parties had the understandings above about the meaning of the disputed term, then the court goes to the next step.

Step Three -- If the court cannot resolve the dispute about a contract term using the steps above, the court must make an objective interpretation of the meaning of the disputed term. If a court takes this third step, it may mean that it cannot be reliably determined what the parties' ideas about the disputed term really were. Or it may mean that the parties had different ideas about the meaning of the disputed term, and both ideas were reasonable or neither was reasonable! Despite these types of problems, if a court can interpret the meaning of the disputed term based on objective rules, the court will do so. It is even possible that a court will find the disputed term had an objective meaning that neither party actually intended, though that seems very unlikely.

In this objective analysis, the court tries to determine what reasonable people would have thought the disputed term meant if they had used it

as the parties did. To do this analysis, courts use the objective rules of interpretation explained in the rest of this Chapter.

CASE STUDY 178

FACTS Vantha goes to a bread seller named Samneang, looking for some big loaves of bread. At Samneang's bread stand, she has two piles of bread: one pile of big loaves, and one pile of small loaves. Vantha points at the pile of big loaves and says she will pay 700 riels for two loaves of bread "like that." Samneang sees where Vantha has pointed. Samneang then says she will sell two loaves of bread for 800 riels. Vantha agrees. Vantha pays the 800 riels, but Samneang gives her two small loaves of bread! Samneang says she meant the small loaves, and Vantha says she meant the big loaves. The parties ask the court to interpret the agreement.

QUESTION OF LAW What did "bread" mean in this agreement?

DECISION The court would probably interpret "bread" to mean the big loaves of bread here, using the "subjective, then objective" analysis outlined above.

When there is a dispute about the meaning of a contract term, many courts use a "subjective, then objective approach" to resolve the dispute. The example of this approach discussed in this text can take up to three steps.

In the first step, there is a determination of whether the parties both had the same particular (subjective) understanding of what the term meant when they made the contract. Here, the term in dispute is "bread." Vantha says she meant big loaves, and Samneang says she meant small loaves. It might be decided that, based on this evidence, both parties meant big loaves when they made the contract--even though Samneang now claims otherwise. If that was decided, the court would apply that meaning to the contract and stop. But if there was not enough reliable evidence to make that finding--such as if it was not clear which party was telling the truth--then the court would proceed to the second step.

Under the second step, the court first asks if the parties had different (subjective) ideas about the disputed term when they made the contract. If the two parties did have different understandings about a disputed term, and either the second party knew the first party's idea even though the first party did not know the second party's idea (subjectively), or the second party should have known the first party's idea even though the first party had no reason to know the second party's idea (objectively), then the court must apply the first party's idea as the correct meaning.

In this case, it might be decided that the parties had different ideas about the meaning of "bread." Specifically, it might be decided that Samneang meant small loaves (since Samneang now says she meant small loaves),

and Vantha meant big loaves (since Vantha now says she meant big loaves). It might also be decided that, at the time the contract was formed, Samneang actually knew that Vantha meant big loaves, but that Vantha did not know that Samneang meant small loaves. If that occurred, then the subjective part of the second step would be satisfied, and there would be no need for the court to proceed. In that case, the court would find that “bread” in this contract meant big loaves.

However, if it could not be reliably determined whether Samneang actually knew about Vantha’s idea that “bread” meant big loaves, then the court would have to perform the objective analysis in the second step. To do that, the court would ask whether reasonable people in the positions of Vantha and Samneang would have had reason to know about the other party’s understanding of the term “bread” in the contract. The court would use different objective rules of interpretation, which will be explained in the rest of this Chapter. But basically, it seems likely that the court would find that Samneang should have known Vantha meant large loaves, because Vantha had just pointed at the pile of big loaves and made an offer to buy bread “like that.” And it also seems likely that Vantha had no reason to know that Samneang meant the small loaves, because of Vantha’s own words and conduct, and because Samneang never said or did anything to indicate she meant small loaves. So it seems the court would probably find that “bread” in this contract meant what Vantha says it did: big loaves of bread.

If the court could not interpret the contract in these first two steps, then it would proceed to the third step, which is to interpret the contract based on objective rules of interpretation, as discussed in the rest of this Chapter. If the court did that, it seems likely that it would still find that “bread” meant big loaves, because of the evidence that Vantha had pointed at the big loaves of bread and asked for bread “like that,” and that Samneang had seen her do it. So even if the court reached this third step, it would probably find that “bread” meant “big loaves of bread” here.

8.3c Rule Number Three: In Interpreting Contracts, Courts Consider the Whole Contract

Although courts are permitted to interpret only the specific terms that the parties dispute in their contract, as discussed in Section 8.2, courts must interpret such terms by seeing how they fit into the whole contract. That is, in order to learn what such disputed terms mean, the court must look at everything the parties put into their contract. This rule reduces the risk that courts will make an incorrect interpretation because they have considered only part of a contract.

Sometimes the contract itself clearly defines or explains the disputed term. In that situation, that definition or explanation is the meaning that the court must enforce. For example, many written contracts contain an entire section with special definitions of important words or phrases in the contract.

This is often true in business contracts, and contracts whose subject matter is very technical. Unfortunately, sometimes even these definitions are not clear enough for the court to find the meaning on that basis alone!

Some parties do not put their entire contract in one place or in one form. For example, a contract may be partly written and partly oral. In that situation, the court must consider both the written and oral parts, assuming that is permitted by other rules such as the parole evidence rule, which will be explained in Section 8.4b below.

In addition, in cases involving written contracts, parties may use several documents to express their agreement. So the contract may consist of more than one document. This was already discussed briefly in Chapter 6 (“Formality”), Section 6.6a, which explained that the law is generally flexible about the form of writings, and that a contract may meet writing requirements even if it consists of several writings. Examples of contracts that often consist of more than one document are contracts involving large scale construction or the sale of goods. So if there is a dispute in such a case, the court must consider all of the documents.

CASE STUDY 179

FACTS The Kompong Construction Company and Sok Phi Investors made an agreement for Kompong Construction to build a large hotel and casino on an island which Sok Phi owned in the Gulf of Thailand. Sok Phi agreed to pay Kompong \$30,000,000 for the project.

When the parties were negotiating their contract, Sok Phi stated that it required the new hotel and casino to be built with the same high quality designs and materials as another one of its properties in Europe. Sok Phi gave Kompong a written description of these designs and materials entitled “Construction Plans and Specifications.”

Later, in the parties’ two-page written contract for the construction, they inserted a clause which said that “construction shall be according to Sok Phi’s ‘Construction Plans and Specifications,’ which are incorporated herein by reference.” That was the only place in the two-page document that said anything about the construction design or materials. Both parties signed the two-page document, but nothing else.

Kompong finished the construction, and Sok Phi paid the \$30,000,000. But three years later, the hotel suddenly collapsed in a mild storm! Both the government and Sok Phi’s own experts investigated the disaster. They discovered that Kompong had used designs and materials of only average quality when it built the hotel--not the high quality designs and materials specified in Sok Phi’s “Construction Plans and Specifications”--and that was why the hotel collapsed.

Sok Phi demanded compensation from Kompong. But Kompong refused, insisting that only the two page document that the parties had signed was valid, and that that document really had no specific requirements about the designs and materials of the hotel and casino. The parties asked an arbitrator to resolve their dispute.

QUESTION OF LAW Would the arbitrator consider more than one document in order to interpret this contract?

DECISION Yes. The contract here included both the two-page document the parties signed and Sok Phi's "Construction Plans and Specifications," so the arbitrator would have to consider both documents to interpret the contract.

When parties ask a court or other decision-maker to interpret their contract, the court or other decision-maker must consider the entire agreement of the parties. This may involve examining more than one document, because sometimes parties express their agreement in more than one document.

In this case, Kompong and Sok Phi agreed that their contract would "incorporate by reference" the "Construction Plans and Specifications" mentioned in the two-page document they signed. So the "Plans and Specifications" were actually part of the contract, even though they were physically separate from the main contract document. To resolve this dispute, the arbitrator must examine the main document and the "Plans and Specifications." When the arbitrator does that, she will probably find that Kompong did not follow the contract.

*** **ADDITIONAL REFERENCE:** Chapter 6 ("Formality"), Section 6.6a explains that writing requirements may be satisfied by several different writings.

8.3d **Rule Number Four: In Interpreting Contracts, Courts Try to Avoid Inconsistency between Terms**

Courts try to interpret contracts so that different parts of the contract do not conflict with each other, if it is reasonable to interpret the contract that way. For example, suppose there is a written contract for the sale of mangoes, and the contract contains several references to mangoes and one reference to durians which is obviously a mistake--since the contract is clearly not about durians. In that case, the court will probably interpret that reference to "durians" to mean "mangoes." Of course, it must be clear that the reference really is a mistake, which may depend on a careful reading of the whole contract, as discussed in Section 8.3c, above.

Of course, this rule does not mean that courts can avoid all inconsistencies or conflicts in a contract. For example, where a conflict between two material (important) terms in a contract cannot be resolved,

the court cannot interpret that part of the contract. In fact, courts generally cannot enforce such contracts at all, because they are probably not definite and reasonably clear. And there is usually no practical way the court can sever the part that cannot be interpreted. This is discussed in more detail in Section 8.5, below. The following Case Study illustrates this basic limit on the ability of courts to resolve inconsistencies.

CASE STUDY 180

FACTS Pin Vipheak signed a contract to sell 200 hectares of good land in Battambang to Tung Yun. One clause of the contract stated that the purchase price was \$100,000. Another clause stated that the price was \$450 per hectare--which would result in a total price of \$90,000. So there was a \$10,000 difference between the two prices in the contract.

Tung Yun tried to pay the lower price (\$90,000), and Pin Vipheak demanded the higher price (\$100,000). There is no reliable evidence to show what the parties actually intended when they made the contract, and no other objective rule can resolve the conflict. The parties ask the court to interpret their contract.

QUESTION OF LAW Can a court interpret the price term in this contract and enforce the contract?

DECISION No. A court cannot interpret or enforce this contract, because there is no way to reconcile the two different price terms.

A court cannot generally interpret a contract which describes the same material term in two completely different ways, where there is no way to resolve the conflict. In this case, the contract states two completely different prices for Pin Vipheak's land--a material term--and it is impossible for the court to resolve the fundamental conflict about the price. This means the contract is not definite and reasonably clear. And the court cannot sever the price term here--it is central to the agreement. So the contract cannot be enforced. This situation could also be analyzed as a bilateral mistake so serious that the court cannot fairly enforce the agreement.

*** **ADDITIONAL REFERENCE:** Chapter 7 (“Other Contract Formation Problems”), Section 7.3a discusses the validity of agreements resulting from bilateral mistakes about the meaning of material terms.

8.3e **Rule Number Five: When Terms in a Contract Conflict, Courts Value Certain Types of Terms More Than Other Types of Terms**

When a court interprets a contract, it looks carefully at all of the terms in the contract. Of course, these terms can be different: some are more specific than others, and some are expressed differently from others.

In particular, certain types of statements show that they have greater value to the parties, because they show more recent agreement, or more specific detail or attention by the parties. When there is a conflict between terms that have different values, many courts will interpret the weaker term to agree with the stronger term. In other words, the stronger term wins. So in this special situation, courts can enforce the terms even if they conflict! But if conflicting terms do not have different values, then it may not be possible to resolve the conflict, as discussed in Section 8.3d, above, and Section 8.5, below.

Courts have some general rules about which types of terms have more value than others. Following are brief explanations of two of the most important of these rules.

(1) Specific terms are valued more highly than general terms. For example, part of an employment contract may say that a permanent employee must work “every day in the work week (Monday through Friday),” but another part of the contract may give the employee 15 specific holidays each year (such as the anniversary of the Paris Peace Accords). If these 15 specific holidays include some that occur during the normal work week (Monday through Friday)--meaning the terms conflict--then the more specific “holiday” term will outweigh the more general “work week” term. In other words, the contract does not require the employee to work on the 15 specific holidays, even though they occur during the normal work week. So a court would enforce the holiday term, and interpret the work week term to agree with it.

(2) Terms which the parties negotiated separately from most of the contract or added to a previously prepared form are stronger than terms the parties did not negotiate separately or which were already on the form. When parties negotiate terms separately from most of the contract, or add them to a form that was created previously, those terms are valued more highly than other terms.

As part of this general rule, many jurisdictions say that handwritten terms are stronger than typewritten terms, and typewritten terms are stronger than terms on a pre-printed “standard” form (such as those that may result in adhesion contracts). The reason for this is that when terms are added separately or later, it usually means the parties gave those terms closer and later attention, and that they intended those terms to be stronger than any conflicting ones. This important rule is illustrated in the following Case Study.

CASE STUDY 181

FACTS The World Agency for Development (WAD) signed a contract with the owner of the Bopha Tower to rent five floors of the Tower for three years. The lease contract was a pre-printed, standard form, with some blanks filled in by typewriting.

A pre-printed clause in the contract required WAD to pay Bopha one lump sum payment of three months rent within 15 days of the signing of the contract, then monthly rent on the first of the month beginning in the fourth month of occupancy. But a typewritten part of the form only required WAD to pay the first month's rent on the day WAD was to move into the building three weeks later, and to pay rent monthly in the same way for the rest of the contract.

Three weeks after the contract was signed, as the WAD staff was moving its equipment into the Tower, the Tower's owner appeared and demanded immediate payment of three months rent! WAD refused, and the owner asked the court for help.

QUESTION OF LAW Does this contract require WAD to pay three months rent within the first 15 days of the contract date, as stated in the pre-printed language?

DECISION No. The court will interpret the lease contract to require payments by WAD on the first day of each month, as the typewritten part of the contract says, because terms that are added to pre-printed forms by the parties are valued more highly than pre-printed terms.

When a contract contains conflicting terms, courts consider the types of the conflicting terms to see if one is valued more highly than another. In particular, separately negotiated terms and terms added later to a pre-printed form are stronger than other terms.

In this case, the conflict is between statements in WAD's lease of part of the Bopha Tower. One statement was pre-printed (the lump sum payment of 3 months rent). The other statement was typewritten later (the first month's rent to be paid on the day WAD moved in and monthly thereafter). While the pre-printed statement was obviously prepared at some time in the past for use in Bopha's leases generally, the typewritten statement was added recently to WAD's specific contract, which was actually signed by both parties in this transaction. The typewritten statement has greater value than the pre-printed statement. So the typewritten term will win. WAD need not make the lump sum payment.

8.3f Rule Number Six: If the Meaning of a Disputed Term Is Not Clear from the Contract, Courts Consider the Ordinary Meaning That a Reasonable Person in the Parties' Situation Would Understand the Term to Have

This rule is also called the "plain meaning" rule. Under the plain meaning rule, when the meaning of a disputed term is not clear from the

contract, the court may make an objective interpretation based on the term's recognized or commonly accepted meaning. In doing so, the court may use:

- (1) the commonly accepted meaning, for ordinary terms; and
- (2) the recognized technical meaning, for technical terms.

In particular, courts use standard, accepted reference works such as dictionaries, technical manuals, statutes, and government regulations for this purpose. Consider the following Case Study.

CASE STUDY 182

FACTS The facts are the same as in Case Study 31, the “what is chicken?” case. As the reader will no doubt recall, a chicken producer named Sombok and a restaurant owner named Cheep agreed that Sombok would supply Cheep with 500 “chickens” each month for one year.

But after the first delivery, a dispute arose about the meaning of “chicken” in the contract. Cheep said he meant young chickens, but Sombok had delivered old chickens, which Sombok claimed satisfied the contract.

QUESTION OF LAW Did this contract require Sombok to deliver young chickens?

DECISION No. The contract did not require the delivery of young chickens because that is not what “chicken” meant in the contract, based on all the applicable rules of interpretation, including the plain meaning of “chicken.”

If the meaning of a term is not clear from the contract, courts consider the “plain meaning” a reasonable person would understand the term to have. In this case, the parties disagreed about the meaning of “chicken” in their contract. To find the plain meaning, the court looked at a dictionary, to check the commonly accepted meaning, and at Ministry of Agriculture regulations, to see if “chicken” had any special technical meaning. Neither of these standard reference works said that “chicken” meant “young chicken.”

The court also looked at the surrounding circumstances, including the course of performance, the course of dealing, and trade usages (which are discussed in Section 8.3h, below). In this case, there was no helpful course of performance, since Cheep objected to the chickens right away. And there were no prior dealings between the parties. However, the trade usage relevant to this case was that, if parties like these wanted a certain kind of chicken (like “young” chicken), they were required to specify that in the contract.

Based on the above rules of interpretation, the court concluded that “chicken” here simply meant “chicken,” as Sombok argued--not “young chicken,” as Cheep argued. Sombok was not required to deliver “young chickens.”

***** WHY IS THIS IMPORTANT?** What is the effect of the plain meaning rule on parties and the interpretation of their contracts?

Probably the most important effect of this rule is that it provides an obvious starting place for the court to find the objective meaning of a term that is not clear in a contract. Often, the court can simply consult a dictionary or technical manual. Definitions in such sources should generally be well known to parties like those involved in the contract. So the rule not only helps courts be efficient in interpreting contracts, but it is generally fair to the parties as well.

In some jurisdictions, the plain meaning rule used to be the most important rule for the interpretation of contracts. In the past, many courts would focus only on the plain meaning of terms the parties used. If the "plain meaning" seemed clear, the court would not consider any other evidence--even if the evidence of the particular circumstances of the parties showed that they actually intended a meaning which differed from the ordinary meaning of the term!

But the plain meaning rule is no longer as strong in many jurisdictions as it used to be. In fact, many courts do not apply the "plain meaning" rule to a disputed contract term if the evidence shows that that would violate the actual intentions of the parties, or other objective rules of interpretation.

For example, sometimes parties do not use language in the way that is commonly accepted as "correct." In English, parties sometimes use the word "and," even though it is likely from the context that they really mean "or." For example, where a lease forbids a tenant to "fire weapons, store dangerous chemicals, and make loud noises," a court would probably interpret the word "and" to mean "or." The reason is that, in English, the "plain meaning" of the above phrase is probably to forbid the tenant to do all three of these activities--but not to forbid her to do only one! However, it seems much more likely that the parties' subjective intention--and the objective meaning based on some of the other rules in Section 8.3--would be to forbid any one of these activities, which would technically require use of the word "or." So in this situation, a court would be likely to interpret the word "and" to mean "or"--even though that may not be the "plain meaning."

Of course, the plain meaning rule is still a useful starting place for courts to make an objective analysis of disputed contract terms. And it can also help courts determine the meaning of a disputed term together with other rules, as in Case Study 182.



8.3g Rule Number Seven: If the Meaning of a Disputed Term Is Not Clear from the Contract, Courts Consider the Main Purposes of the Parties When They Made the Contract.

The main purposes of the parties when they made their contract are also important factors to consider in interpreting the meaning of disputed terms in a contract. Sometimes the contract itself describes its main purposes. Other times the court can determine the main purposes of an agreement by determining what kind of agreement it is, or by looking at other reliable evidence.

CASE STUDY 183

FACTS After twelve years of marriage, the shop owners Samon and Vanny divorced. As part of their written divorce agreement, Samon agreed to provide a specific amount of financial support each month for the parties' eleven-year-old son Vannith, and Vanny agreed to actually take care of Vannith. The agreement did not say how long Samon's obligation lasted, but it did say that one of the agreement's main goals was to provide care for Vannith until he became an adult.

Vannith is now 18, which is the age of majority under the relevant statute. Samon has decided to stop giving money to Vanny for Vannith's support. But Vanny asks the court to order Samon to continue paying support.

QUESTION OF LAW Does the divorce agreement require Samon to continue paying support for Vannith after Vannith becomes 18 years old?

DECISION Probably not. A court would probably interpret Samon's obligation to pay to end when Vannith reached the age of 18, since one of the main purposes of the agreement was to take care of Vannith until he became an adult.

When courts interpret contracts, they consider the parties' main purposes in making the contracts. In this case, when Samon and Vanny made their divorce agreement, Samon promised to pay a certain amount each month in child support. The agreement did not specify how long Samon's obligation lasted. But the parties did state that one of their main goals was to provide for Vannith until he reached adulthood. Of course, even if they had not said that, providing for children until they reach adulthood is usually one of the main goals of divorce agreements. Adulthood is often measured by the age of majority, which is 18 years in this jurisdiction. And in fact, one of the major reasons the relevant statute defines the "age of majority" is to show that parents are responsible for the care of their children until that age. Since adulthood generally begins at the age of majority, it seems likely that the parties' divorce agreement required Samon to provide support for Vannith until he reached that age. Vannith has reached that age: 18 years. So courts

would likely interpret the divorce agreement to mean that Samon has no further obligation under the agreement to support her son.

8.3h Rule Number Eight: If the Meaning of a Disputed Term Is Not Clear from the Contract, Courts Consider All the Surrounding Circumstances, Particularly the Course of Performance, Prior Dealings between the Parties, and Trade Usages

In interpreting contracts, courts consider all the circumstances surrounding the contracts. Many different kinds of circumstances may be relevant to the meaning of terms in the contract. However, probably the three most important kinds of such circumstances--in order of importance--are:

- (1) the parties' course of performance of the contract (most important);
- (2) prior dealings (or course of dealing) between the parties (second most important); and
- (3) trade usages relevant to the contract (third most important).

The reason for this order of importance appears to be that evidence of the parties' course of performance of a contract would be the closest evidence to the actual contract. Evidence of the parties' prior dealings would be the next closest, since it would still be about these particular parties (though not this contract). And trade usages would be least close, since those would not be about these particular parties at all. These circumstances are explained below.

(1) Course of Performance

The first kind of surrounding circumstances that many courts examine in interpreting contracts is the parties' "course of performance." Course of performance basically means any conduct by the parties after they made their contract which shows that they probably shared the same idea about a disputed term, or at least that the actions of one party are not consistent with the understanding she now says she had. In a way, this analysis seems partly subjective, since it focuses on what the particular parties probably meant, based on their actions. But the analysis is objective in the sense that it focuses on whether a reasonable person would have acted a certain way after the contract was formed if she did not have the same understanding as the other party about the meaning of the disputed term.

Often a party performs a contract in a particular way for some time before the other party objects. Sometimes this performance--and the other party's failure to object--can help the court decide the meaning of a disputed contract term.

CASE STUDY 184

FACTS An experienced car dealer named Big Bear Car Company signed a contract to import 200 used cars per month for one year from the Terrible Tiger Car Company. The contract specified that Terrible Tiger would deliver the cars to Big Bear "in full working order with paint like new."

For the first six months, Terrible Tiger delivered the cars to Big Bear, and Big Bear accepted and sold the cars with no problem. But in the seventh month, a Big Bear customer told a Big Bear salesman that he did not like Big Bear's cars because the paint was old. Then Big Bear's President found out that although Terrible Tiger had cleaned and polished every car before delivery, Terrible Tiger had never re-painted any of the cars that Terrible Tiger had sent to Big Bear during the past 6 months!

Big Bear's President told Terrible Tiger that their contract required Terrible Tiger to re-paint all of the cars before sending them to Big Bear. In response, Terrible Tiger said that the contract only required the paint on Terrible Tiger's cars to look new, not be new. Now Big Bear is suing Terrible Tiger for violating their contract.

QUESTION OF LAW Did the agreement between Terrible Tiger and Big Bear require Terrible Tiger to actually re-paint the cars before delivering them to Big Bear?

DECISION Probably not. Big Bear's acceptance--without objection--of the un-re-painted cars Terrible Tiger sent for six months (the course of performance) suggests that the agreement did not require that the cars actually be re-painted.

In interpreting agreements, an important type of circumstance courts examine is the parties' conduct after the agreement is made, or the course of performance. In particular, where the meaning of a disputed term is unclear, courts may base their interpretations on the performance of the contract by one party, if the other party knew about and accepted that performance without objection.

In this case, Big Bear and Terrible Tiger disagree about the meaning of the words "with paint like new" in their contract. Big Bear says that it intended those words to require Terrible Tiger to actually put new paint on all the cars before sending them to Big Bear. Terrible Tiger says that those words only meant Terrible Tiger had to deliver cars that appeared to have new paint. The plain meaning of the words of the contract probably supports Terrible Tiger's idea, primarily because of the word "like."

But in addition to the words, the court will consider the conduct (course of performance) of Terrible Tiger and Big Bear during the first six months of the performance of the contract. During that time, Big Bear received and

resold 1,200 cars--none of which had actually been re-painted--and made no objection to Terrible Tiger. So it appears that if an experienced car dealer like Big Bear thought "with paint like new" meant Terrible Tiger was required to actually re-paint the cars, Big Bear would have complained to Terrible Tiger much earlier. But Big Bear did not. This course of performance supports Terrible Tiger's idea about what "with paint like new" means. In this situation, the facts show one party's (Terrible Tiger's) repeated performance, plus the other party's (Big Bear's) failure to object, even though that other party (Big Bear) had a reasonable opportunity to object. So the court will probably determine that Terrible Tiger's idea of the meaning of the disputed term is the right one, and Big Bear will not be able to get a remedy.

(2) Prior Dealings (Course of Dealing)

The second most important type of circumstance courts examine when analyzing a disputed part of an agreement is any similar prior dealings between the parties. This is also called the "course of dealing." In particular, courts look at any dealings between the parties before they made their contract which show that, in similar situations in the past, the parties probably shared the same understanding of the disputed term. Such prior dealings may suggest a reasonable interpretation of the term in the current case, or at least that one party should have known that was the understanding of the other party. Use of this analysis is especially common in sale of goods contracts.

This type of analysis is similar to the "course of performance" analysis discussed above. Both focus on a pattern of conduct by the parties and failure by one party to object. And course of dealing is also similar to course of performance in the sense that it has a subjective element, which focuses on what the particular parties in the case probably intended, based on their own actions.

*** CASE STUDY 185

FACTS Three years ago, Seang Veng signed a contract with Rith Realty Co. In the contract, Veng promised to work "full time" as an agent for the company in exchange for 10% of the company's net profits. Veng worked very hard for the company, and he was very successful. In fact, Veng was so successful that Rith, the owner, did not mind when Veng privately arranged and profited from a couple of real estate sales each year. In fact, Veng's boss even congratulated him on his good luck!

Recently, Rith and Veng signed a new, more formal contract, with basically the same terms as the old contract. Veng continued to work successfully for the company, and he also completed two new real estate sales for personal profit. However, this time the boss became angry when he found out! He said that such conduct violated Veng's promise to work "full time" for Rith Realty. The boss asks the court to order Veng to give 90% of his profits from the two sales to the company.

QUESTION OF LAW Did Veng's recent private real estate sales violate his contract promise to work "full time" for Rith Realty?

DECISION Probably not. Veng's private real estate sales probably do not violate his promise because of his similar prior dealings with Rith, during which Rith made no objection to Veng's private sales activities.

When parties argue about the meaning of a contract term, a court may be able to interpret that meaning based on what those parties did together before they made the contract--their prior dealings. In this case, Veng and Rith Realty disagree about the meaning of the term "full time" in Veng's contract. In particular, Rith claims that "full time" means Veng can work only for the profit of Rith Realty. Veng says the contract has no such restriction.

One way to help resolve this dispute is to look at what Veng and his boss did under their prior contract. During the three years Veng worked under the old contract, Veng worked for Rith Realty and for himself. He made profits on a few private sales, and kept them for himself. The boss knew that, and not only did he not object--he even congratulated Veng! If the boss had wanted to make a different arrangement about Veng's private sales--or to forbid them--in the new contract, the boss could have. But he did not. It appears that the parties' prior dealings--including Rith's failure to object to the private sales--show that "full time" employment under this contract does not mean Veng is forbidden to make the private sales. So Veng will probably not be required to give Rith any profits from the two recent private sales.

(3) Trade Usages

The third most important type of circumstance courts examine when analyzing a disputed part of an agreement is trade usages or practices related to the type of contract the parties made. Courts look at such business customs to see if that will help them interpret the meaning of the disputed term.

In general, trade usages apply to a contract if they occur regularly enough, in the community relevant to the contract, that reasonable parties would expect the usage to occur in the contract. It might be difficult to decide cases like this if the parties were not from the same community. So many courts generally examine practices that relate to contracts similar to the contract of the parties in the place where the parties either made or performed their contract. Courts may also rely on industry codes and expert witnesses for evidence of such practices, as discussed in Section 8.4a below.

CASE STUDY 186

FACTS Sombok Home Builders and Olympic Developers signed a contract for Sombok to build 50 new houses in an area near the market. The contract required "turn-key construction, which Sombok shall complete no later than 18 months after the signing of the contract." On March 1, 1994, the President of

Sombok Home Builders and one of the general partners of Olympic Developers signed the contract.

Eighteen months later, Sombok showed Olympic the 50 houses it had built--but none of them were complete! In fact, half of the houses did not have windows yet, and none of the exteriors were finished. The President of Sombok explained that his window supplier had no more of the particular window that Olympic had specified and was trying to find more, and that the exteriors had not been finished because of weather problems. The Olympic partners were furious.

Unfortunately, Sombok did not finally finish the houses until 3 months later. Olympic said that was a breach of their contract, and demanded compensation from Sombok for lost sales and damage to its reputation. Olympic said the contract required the houses to be totally finished within 18 months--ready for occupiers to "turn the keys." But Sombok refused to pay, claiming that since all the doors and locks were in place within 18 months, it was possible to "turn the keys!"

QUESTION OF LAW Did Sombok fail to complete the construction of the houses as required by its contract with Olympic?

DECISION Yes. Sombok failed to perform the contract correctly because it failed to achieve "turn-key construction" within 18 months, under the usage of trade in the construction industry.

Sometimes parties to a contract use technical terms related to their business or activity, but do not define the terms in the contract. When such parties later have disputes about the terms, courts may resolve the disputes by determining what the terms generally mean in the business or activity of the parties--the trade usage.

In this case, Sombok promised "turn-key construction" of 50 houses within 18 months of the signing of its contract with Olympic. Unfortunately for Sombok, the term "turn-key construction" is a technical term with a specific meaning in the construction industry. In the trade usage of this industry, "turn-key construction" means construction which is so complete that the owner only has to "turn the key" in the lock to open the building for use. In other words, nothing else needs to be done on the structure. Here, Sombok failed to complete the houses to that extent within 18 months. So Sombok failed to perform the contract correctly.

8.3i **Rule Number Nine: Disputed Terms Are Interpreted Against the Party Who Drafted the Contract, If That Is Reasonable in the Circumstances**

Sometimes contracts are drafted by only one party. In that situation, if there is a dispute about the meaning or effect of a contract term,

courts generally interpret the disputed term against the drafter, as long as that is reasonable in the circumstances. The reason for this rule is that courts assume that parties who draft contracts protect their own interests in drafting them. So courts generally act to protect the reasonable expectations of the parties who did not draft the contracts! This principle is basically applied in two rules, which are discussed below.

(1) Where the meaning of a disputed term is not clear, courts generally interpret that term against the drafter of the contract, as long as that is reasonable in the circumstances. This rule applies only where the meaning of a disputed term is unclear, and where one party drafted the contract. The rule does not mean that courts make unreasonable interpretations just so they can hurt drafters! It means only that, in choosing between reasonable meanings for unclear terms, courts generally choose the meaning that does not favor the drafter, if there is such a meaning.

For example, an insurance policy holder may sign an insurance contract drafted by the insurance company. If one provision of the policy says the coverage is “comprehensive,” and there is a dispute about what the policy covers, most courts would interpret that word against the insurance company--against the drafter. Of course, that does not mean that such an insurance policy would cover all possible risks. It means only that, if the court must choose between a reasonable meaning that favors the insurance company and a reasonable meaning that does not, it will generally choose the meaning that does not favor the company.

(2) In adhesion contracts, where one party drafts the contract, many courts will not enforce terms that a reasonable other party would not expect to be in the contract, and to which that other party would not have agreed if she had known--even if the meaning of those terms is clear! This rule was already explained briefly in Chapter 7 (“Other Contract Formation Problems”), Section 7.3b, regarding unilateral mistakes that result from a failure to read the contract. Adhesion contracts are discussed in more detail in Chapter 7, Section 7.7b and Case Study 172. As explained in those Sections, adhesion contracts are those drafted by a party who has much greater bargaining power, and presented to the other party in a situation where that party has no real opportunity to bargain about the terms--which are usually standardized in a pre-printed form, and very favorable to the stronger party. Although this important rule is really about enforceability, some authorities also consider it to be a rule of interpretation, since the court might decide to enforce the contract--but without some part that is extremely favorable to the drafter.

One important kind of clause that courts encounter in this area is a “hold harmless” clause.

***** DEFINITION:** A **hold harmless** clause is basically one in which a party agrees to be responsible for the potential legal liability of another party.

For example, one party might agree not to make any future legal claims she would otherwise have a right to make against the other party. This kind of clause is usually very important, because the party who agrees to “hold” the other party “harmless” usually surrenders great legal rights. So before a court will enforce such a surrender, the evidence must convince the court that the surrender was clear and voluntary. For example, if the evidence showed that both parties were sophisticated in contract matters, or that they had actually negotiated the “hold harmless” clause, then the court could enforce the clause. But with adhesion contracts, such circumstances often do not exist.

Hold harmless clauses are similar to exculpatory clauses. Those were explained in Chapter 5 (“Legality”), Section 5.4g, and Chapter 7 (“Other Contract Formation Problems”), Section 7.7b.

CASE STUDY 187

FACTS Intergas, Inc., a huge foreign oil company, offered a pre-printed contract to Sure Service Stations in which Intergas promised to provide petrol to the two Sure Service Stations in Kandal Province for ten years. The Intergas representative told Hing Kosal, the owner of Sure Service, “take it or leave it!” The Intergas representative also told Kosal that the contract was the best offer that Sure Service would get, and that Intergas would wait only a short time for Kosal’s decision.

The contract was written in the language of Intergas’ home nation. It included a “hold harmless” clause, which said that Sure Service would not claim that Intergas was responsible for any damage or injuries that any of Intergas’ employees or agents caused while doing Intergas work (such as gasoline delivery or inspection of equipment) at any Sure Service Station. On the whole, the contract seemed good to Kosal, especially because few oil companies were offering such an arrangement in Cambodia at the time. So even though Kosal was not fluent in the language of the contract and had never studied law, he signed the contract.

Two years later, a new Intergas employee started pumping gas into the wrong tank at one of Kosal’s service stations, and an explosion seriously injured Kosal. When Kosal asked Intergas for compensation, Intergas said that it had no responsibility to Sure Service for the accident because of the “hold harmless” clause in the contract. Kosal brought his claim to the court.

QUESTION OF LAW Will the court enforce the “hold harmless” clause in the contract between Intergas and Sure Service?

DECISION Probably not. The clause is probably not enforceable because it is an adhesion contract term that is so unfair that Sure Service would not reasonably have expected it, nor have agreed had it known of the clause.

In interpreting adhesion contracts, many courts will not enforce parts of the contracts that a reasonable other party would not expect and not agree to if she knew. In this case, the contract between Intergas and Sure Service was a pre-printed form which a large international company presented to a small local business. The contract was written in a foreign language that the signing party (Kosal) did not understand well. It affected legal rights that Kosal had not been trained to understand. And Intergas had little competition in the area, so it had great bargaining power. Finally, Intergas told Kosal to “take it or leave it,” which showed that Kosal had to accept the contract--quickly--as Intergas had drafted it, or not make the contract at all. This is an adhesion contract.

In addition, the “hold harmless” clause in the contract was severe. It stated that Sure Service would make no claims for any harm caused by Intergas’ employees or agents. And Sure Service did not negotiate the “hold harmless” clause before signing the contract. In fact, it appears that a reasonable party in Sure Service’s position would not have expected such a clause, and would not have agreed to such a clause if it had known of it. So the “hold harmless” clause in this case is probably unenforceable. Sure Service can seek damages against Intergas for the accident. The clause may also be unenforceable because it is an exculpatory clause which is against public policy, and because it is substantively unconscionable.

Of course, under basic principles of contract law, parties are generally responsible for all contracts that they make. But when the evidence shows circumstances like those above, courts examine the contract very carefully, and interpret it to prevent unjust domination by the party who prepared it.

*** **ADDITIONAL REFERENCE:** Chapter 5 (“Legality”), Section 5.4g discusses how exculpatory clauses may be unenforceable even as to negligence if they are against public policy; and Chapter 7 (“Other Contract Formation Problems”), Section 7.3b discusses how a party may avoid an adhesion contract clause resulting from unilateral mistake, and Section 7.7b discusses adhesion contracts and unconscionability.

8.3j **Rule Number Ten: Courts in Many Jurisdictions Interpret Contracts to Contain Specific Terms That the Law Requires or Allows, If the Parties Omitted Those Terms.**

An important general rule of contract interpretation is that courts cannot impose contract obligations to which the parties never agreed, because of the freedom of contract, as discussed in Section 8.3a above. However, there are certain situations where the law allows--or even requires--courts to interpret agreements to contain certain terms if the parties omitted those terms from their agreement. The specific reasons for these exceptions are explained below. But in general, they are to protect the parties to the contract from certain kinds of unfairness, to protect their reasonable expectations, and to promote enforcement of contracts and efficient economic activity.

Situations where courts say (or “imply”) that contracts have certain terms may be divided into two main categories:

- (1) situations where the law requires courts to consider particular terms to be part of contracts, such as the duty of good faith and fair dealing; and
- (2) situations where the law allows courts to provide certain kinds of terms to resolve disputes, such as the “gap-fillers” for sale of goods contracts.

These two important categories are discussed below.

(1) Many Jurisdictions Require Courts to Consider Certain Specific Terms, Such As the Duty of Good Faith and Fair Dealing, to Be Part of Contracts If the Parties Omitted Them

In many jurisdictions, the law requires certain special terms to be considered part of all contracts, or all contracts of a certain type. Two important examples of such special terms are warranties, and the duty of good faith and fair dealing.

As discussed in Chapter 7 (“Other Contract Formation Problems”), Section 7.7b, laws in many jurisdictions say that certain warranties are part of all contracts of a certain type, whether the parties actually put them in the contract or not. Examples in some jurisdictions include the warranty of merchantability in sale of goods contracts, and the warranty of habitability in residential lease contracts. Requirements like these try to protect parties from unfairness, and protect their reasonable expectations.

Perhaps the most important term that many jurisdictions consider to be part of all contracts is the implied duty of good faith and fair dealing. Good faith and fair dealing was briefly discussed in Chapter 7, Section 7.4a.

***** DEFINITION:** The **duty of good faith and fair dealing** basically requires a party to a contract to be honest and not seek unfair advantage over the other party (good faith), and to follow reasonable standards of fair conduct in the type of contract the parties made (fair dealing).

Since many jurisdictions say this duty is implied in all existing contracts, it applies to the performance and enforcement of contracts. Common law jurisdictions generally say that this duty does not apply before a contract is formed (in the negotiation stage). Some do say the duty may apply in the negotiation of renewals of existing contracts, or to new contracts whose subject matter is related to old contracts between the parties. In addition, a violation of a duty of good faith and fair dealing is one of the requirements for a party to show that a mistake regarding a basic assumption resulted in misrepresentation in the inducement, as discussed in Chapter 7, Section 7.4a.

But in general, common law jurisdictions have other ways to regulate the conduct of parties before an agreement is formed, such as the rules about procedural unconscionability and other contract defects.

However, it appears that many civil law jurisdictions do impose duties comparable to the duty of good faith and fair dealing before a contract is formed--at the negotiation stage--and in the performance of the contract. For example, it appears that the laws of France and Germany impose comparable duties on parties at the negotiation stage, before any enforceable contract is formed.

Even within a particular jurisdiction, the rules about the duty of good faith and fair dealing do not always apply the same way. In some situations, courts may apply only the “good faith” standard, and not any duty of “fair dealing.” For example, the Uniform Commercial Code in the United States seems to apply only a “good faith” requirement to sale of goods contracts generally. But where such contracts involve merchants, the Code applies that good faith requirement and a “fair dealing” requirement to the merchants.

Some types of situations where conduct violates the duty of good faith and fair dealing include: a lack of diligence in performing a contract; intentionally giving an imperfect performance of a contract; and interfering with the other party’s ability to benefit from the agreement or the other party’s performance. Consider the following Case Study.

CASE STUDY 188

FACTS Two brothers named Rotana and Sochea are both famous popular singers. They make separate contracts with a nightclub owner named Vandy to sing on the same night, one right after the other.

On the night the brothers are scheduled to appear, Rotana goes first. However, because he is a big star, Rotana decides that he does not need to try very hard. So he intentionally sings badly. Vandy and her customers are very upset. In fact, Vandy is so angry that--in order to get revenge on the brothers--when Sochea gets on stage and starts to sing, Vandy tampers with the sound system so that Sochea’s microphone keeps going off and on, and the volume keeps going up and down! This makes it very difficult for Sochea to sing, though he tries to do so. Of course, it also annoys the audience, but Vandy is too angry to care.

The next day, Vandy says Rotana violated his duty of good faith and fair dealing, even though there are no express contract provisions about how he was to perform. And Sochea says that Vandy violated her duty of good faith and fair dealing, even though there are no express provisions forbidding her to tamper with the sound system.

QUESTION OF LAW Did Rotana and Vandy violate their duties of good faith and fair dealing?

DECISION Perhaps. Some jurisdictions might say that Rotana and Vandy violated their duties of good faith and fair dealing, even though it appears that they violated no express provisions of their contracts.

Many jurisdictions say that a duty of good faith and fair dealing exists in all contracts. In this case, Rotana and Sochea agreed to sing at Vandy's nightclub. But Rotana intentionally sang badly. Even though it appears that he met the express requirement of the contract--that he "sing"--a court might find that he had intentionally rendered an imperfect performance, performed with a lack of diligence, and interfered with Vandy's right to receive the benefits of her agreement: a good performance and happy customers. Some courts might find that this violated his duty of good faith and fair dealing.

And Vandy intentionally interfered with Sochea's performance by tampering with the sound system, making it very difficult for Sochea to sing. Although no express provision of the parties' contract discussed this, Vandy's actions interfered with Sochea's performance, and prevented him from receiving all the benefits of the agreement, since one of the benefits of such agreements is the opportunity to build and maintain a good reputation as a singer. So some jurisdictions might say that Vandy violated the duty of good faith and fair dealing.

In general, the actions of Rotana and Vandy do not show "good faith," and do not follow reasonable standards of fair conduct for this type of contract. So some jurisdictions might find that they violated the duty of good faith and fair dealing.

Many jurisdictions say that, in certain special situations, to breach a contract in violation of the duty of good faith and fair dealing--in "bad faith"--is actually a tort. However, courts have had trouble defining exactly when the tort exists. Most courts have been careful to limit this tort to certain types of cases. Basically, these cases seem to occur where:

- (1) there is some special relationship between the parties to the contract which involves elements such as the public interest and adhesion;
- or (2) a party's conduct in breaching is notably malicious, oppressive, unreasonable, or unjustifiable.

Probably the most important area in which courts have found this to occur is in insurance contracts. It may occur where an insurance company refuses in bad faith to pay a claim submitted by one of its policyholders. Another situation where some courts have found the tort of bad faith to exist is where a party denies without any legitimate reason that a contract even exists. In situations like these, punitive damages may be available, even though

punitive damages are not generally ordered in contract disputes. This will be discussed in more detail in Chapter 10 ("Remedies"), Section 10.5d.

***** ADDITIONAL REFERENCE:** Chapter 7 ("Other Contract Formation Problems"), Section 7.4a discusses the duty of good faith and fair dealing in the context of misrepresentation in the inducement, and Section 7.7b discusses the warranties that may be implied in certain types of contracts; Chapter 9 ("Performance and Discharge of Duties"), Section 9.5c discusses how the duty of good faith and fair dealing affects contract performance; and Chapter 10 ("Remedies"), Section 10.5d discusses how a bad faith breach of contract can be a tort in limited situations.

(2) Many Jurisdictions Allow Courts to Supply Certain Terms to Contracts in Order to Resolve Disputes, Such As "Gap-Fillers" for Sale of Goods Contracts, If the Parties Omitted Them

The law in many jurisdictions allows courts to supply certain types of terms to contracts in order to resolve disputes, if the parties omitted the terms. Although many jurisdictions did not allow this practice in the past, many courts deciding contract disputes will now attempt to supply such terms in a variety of situations, as long as it is consistent with the apparent intentions of the parties.

For example, courts in many jurisdictions will supply a "reasonable" price term to a sale of goods contract if the parties have failed to specify any price term. The reason courts are allowed to do this in certain situations is to protect the reasonable expectations of the parties. This rule also promotes the enforcement of contracts where the parties did not have time to put all the terms in their contracts, or where they simply assumed reasonable terms would apply. This is especially important in business contracts.

However, it is important to remember that courts cannot supply missing terms in every situation. In fact, they cannot supply the truly essential terms that were discussed in Chapter 2 ("Real Agreement (Offer and Acceptance)"), Section 2.3b--the terms needed for an offer to be definite and reasonably clear. For example, in most contracts, courts cannot supply a missing description of the subject matter of the contract, such as the identity and quantity in a sale of goods contract. There is generally no way for courts to determine such terms.

In addition, courts cannot supply a term which the parties themselves have already specified in their contract. This is true even if the parties have tried to specify the term, but failed to do so clearly enough for the term to be interpreted! So if the parties do say something about a term, but the court cannot interpret it under any of the rules of interpretation, the court cannot substitute its own "reasonable" term. The reason courts cannot supply terms in these situations is that the risk of harming the reasonable expectations of

the parties would be too high. If the parties have specified--or tried to specify--their own term, courts assume they do not want a “reasonable” term.

Perhaps the most important examples of this rule are the “gap-fillers” that many jurisdictions will supply for sale of goods contracts. Some commercial laws (such as the Uniform Commercial Code in the United States) allow courts to supply reasonable terms for sale of goods contracts if the parties have failed to say what they meant about certain types of terms. One way the law does this is by providing a list of specific gap-fillers that courts may supply where the parties have failed to state that specific term. For example, where a sale of goods contract has no price term, a court may be able to supply a reasonable price, as in Case Study 35. Another way some commercial laws (such as the Uniform Commercial Code) fill gaps is by allowing courts to supply missing terms by looking at the surrounding circumstances described in Section 8.3h above: the course of performance, prior dealings, and trade usages. In these ways, such commercial laws help courts resolve disputes about important terms which are missing from contracts.

CASE STUDY 189

FACTS One day in New Market, a trader named Var Hach agrees to sell a merchant named Tung Chhay 10 cartons of videos for \$500. Chhay pays Hach in advance, because Hach has a good reputation at the market. The parties say nothing about when delivery is to occur.

Three months later, Hach has not delivered the videos. So Chhay demands his money back. Hach tells Chhay to wait a little longer. But after another month, Hach has still not delivered the videos.

Finally, Chhay complains to the court, saying he has waited a reasonable time but received no videos. Hach says that the parties never agreed about a delivery date, so either their contract was void, or Hach still has time left to make the delivery.

QUESTION OF LAW Do Hach and Chhay have an enforceable contract that requires delivery of the videos to occur within a reasonable time, and did Hach fail to comply with that requirement?

DECISION Yes, in many jurisdictions. Under many commercial laws, courts imply a requirement that delivery of goods occur within a reasonable time, and in this case Hach failed to follow that term of the contract.

Commercial laws in many jurisdictions say that courts can supply certain types of terms when parties fail to include them in sale of goods contracts. One of the types of terms courts can supply is the time for delivery of the goods. If parties fail to include this term, courts say delivery must occur within a reasonable time.

In this case, the sale of goods contract does not say when Hach (the seller) must deliver the videos to Chhay (the buyer). In many jurisdictions, the court can “fill that gap” about delivery. First, the contract is not void because a “gap-filler” can supply the missing term: the time for delivery. Under this gap-filler, Hach has only a reasonable time to deliver the videos. Here, where Hach failed to deliver the videos for four months, most courts would probably say that a reasonable time has passed. So Hach has failed to deliver within a reasonable time under the contract. The court can order Hach to provide a remedy to Chhay.

These gap-fillers for sale of goods contracts are based on what is generally considered fair in commercial contracts, and on what parties usually expect when they make such contracts. The following illustration shows some important specific gap-fillers under the Uniform Commercial Code in the United States.

Illustration: Some Important “Gap-Fillers” for Interpreting Sale of Goods Contracts (U.S. commercial code)		
IF neither the contract nor other evidence shows what the parties intended with regard to:		the court may imply--“fill the gap” with--the following term:
(1) PRICE		A <u>reasonable price</u> at the time the seller is to deliver the goods to the buyer (See Case Study 35)
(2) TIME OF PAYMENT.....		The buyer must <u>pay in full at the time the seller delivers</u> the goods (the buyer does not receive credit)
(3) PLACE OF PAYMENT.....		The buyer must pay at the <u>place of delivery</u>
(4) TIME OF DELIVERY.....		The seller must deliver within a <u>reasonable time</u> (See Case Study 189)
(5) METHOD OF DELIVERY		The seller must deliver <u>all the goods in one delivery</u>
(6) PLACE OF DELIVERY		The seller must deliver the goods <u>at the seller’s place of business</u> , or at the seller’s residence if the seller has no place of business (except where both parties already know the goods are in a particular place, in which case that is the place of delivery)

***** WHY IS THIS IMPORTANT?** Why do many commercial laws provide “gap-fillers” for sale of goods contracts?

Lawmakers created these gap-fillers in order to support sale of goods contracts. In fact, courts use gap-fillers to resolve disputes and enforce commercial contracts as much as possible. In addition, the gap-fillers allow parties to make more contracts faster, without having to negotiate every term in every contract. This promotes business and commercial activity. So the gap-fillers have the same basic function as many other special rules for sale of goods contracts.

Of course, it is often better for the parties to avoid “gaps” about important matters in their contracts. This is especially true when a party has a special need or goal that requires a particular term that is different from the standard gap-filler in the commercial law. In such cases, if the parties themselves do not provide the term they want, the commercial law may provide a gap-filler the parties never wanted and do not like--and then the parties must obey the contract with the law's gap-filler in it! So parties should generally try to specify exactly what they want in their sale of goods contracts, even where the law provides gap-fillers.

*** **ADDITIONAL REFERENCE:** Chapter 2 (“Real Agreement (Offer and Acceptance)”), Section 2.3b further discusses how courts in some jurisdictions can supply certain terms to sale of goods contracts, and the reasons sale of goods contracts often need not be as definite as contracts in general.

8.4 Evidence Courts Use to Interpret Contracts

Below are some general principles about the kinds of evidence many courts use to help them interpret contracts. Of course, the specific rules about what evidence courts may use to interpret contracts vary in different jurisdictions. So as always, it is important to check the local law.

8.4a Courts May Use Various Types of Evidence

Courts may generally use a variety of different types of evidence to interpret contracts. Often this evidence helps them apply the rules discussed in Section 8.3. These are some important types of evidence courts may use:

- (1) the contract itself (which may be oral, implied, written in one or more documents, or some combination of these possibilities);
- (2) other documents that contain information relevant to the contract;
- (3) testimony from the parties;
- (4) testimony from other witnesses; and
- (5) standard reference materials, including:
 - (a) regular and technical dictionaries; and
 - (b) industry manuals.

However, the rules of contract law and the rules of evidence limit the use of some of these types of evidence in interpreting contracts. Perhaps the most important single limit in common law jurisdictions is the “parol evidence rule,” which is discussed in Section 8.4b below.

In addition, it appears that many civil law jurisdictions limit the use of testimony (oral evidence) in contract disputes more than most common law jurisdictions do. It seems that such jurisdictions try to resolve contract disputes primarily on the basis of documentary evidence.

8.4b Under the Common Law Parol Evidence Rule, Where a Final Writing Contains Contract Terms, a Court Cannot Generally Allow Evidence of Statements of the Parties Prior to That Writing to Contradict or Add to the Terms of a Complete Writing, or Contradict the Terms of an Incomplete Writing

In many common law jurisdictions, such as Australia, there is an important limit on how evidence may be used where there is a written contract. This is the “parol evidence rule.”

In many jurisdictions, under the parol evidence rule, where a contract is written, final, and complete, a court cannot generally allow evidence of statements made by the parties prior to the signing of the writing to contradict or add to the writing’s terms. Where such a writing is final but not complete, a court cannot generally allow such prior statements to contradict the terms in the writing, though they may add consistent terms.

The “statements” covered by the rule include oral and written statements. The rule covers not only brief comments by the parties, such as “delivery in three days,” but also statements by the parties that actually look like full, detailed agreements. For example, if a contract is written, final, and complete, and includes a price term, a court cannot allow evidence of a different price term contained in a prior document the parties prepared--even one entitled “Agreement”--to contradict the price term in the final contract. Nor can the court allow evidence that a party said orally that the price would be some different amount just before the parties signed the final agreement to contradict the price term in the final agreement.

This rule helps protect the interests of the parties who made a final written contract. And it also helps courts interpret contracts, by encouraging parties to create a single source of written proof of the contract. Courts do not wish to go through the whole negotiation process the parties did--which may have involved large numbers of different draft documents, and many conversations--in order to find the parties’ true agreement.

The parol evidence rule is difficult, but it is important to remember that it applies only in limited situations. The rule only stops courts from allowing prior statements to contradict the terms in any final writing, or add to

the terms in a complete final writing. So it does not stop the court from using such statements to decide whether a writing actually is complete. It does not stop the court from using such statements to help the court understand the meaning of the terms in the writing where they are not clear. In addition, the rule does not apply to statements made after the contract is formed, such as modifications of the agreement. And the rule does not apply to evidence used to make claims that the contract is not valid, such as claims that there are problems with legality or capacity, or other formation problems, like mistake. These limits on the parol evidence rule are discussed in detail below.

The name “parol evidence rule” may be a little confusing. The English term “parol” appears to be related to a French word meaning “oral.” But the rule actually applies to prior oral and written statements that parties may seek to use in court to contradict or add to contract terms. In addition, the name might be confusing because, although the rule says it is an “evidence rule,” it is generally considered to be a substantive contract law rule. This is because the rule really guides what the terms of a contract are, not just what evidence a court will consider.

(1) When the Parol Evidence Rule Applies

As noted above, the parol evidence rule applies only in particular situations. In order to determine if the rule applies, a court must answer three questions:

- (1) Did the parties create a writing?
- (2) Was that writing the final expression of the parties’ agreement?
- (3) Was that writing the complete expression of the parties’ agreement?

Suppose the answer is yes to all three questions--that is, the contract is written, final and complete. In that case, the court will not allow evidence of prior statements of the parties to contradict or add to the contract terms.

Suppose the answer is yes to the first two questions but no to the third question--because there is a written and final expression of the parties’ agreement, but it is not complete. In that case, the court will not allow prior statements to contradict what is in the writing. But the court will allow such evidence to add consistent terms.

Finally, suppose the answer is no to either one of the first two questions--because there is no writing, or because the writing is not final. In that case, the parol evidence rule does not apply. So the court may consider evidence about the contract according to the regular rules of evidence.

These three key questions are explained in more detail below.

(1) Is there a writing? The parol evidence rule applies only where there is a writing. So if the parties' agreement is oral or implied, the rule does not prevent the court from allowing prior statements to change the terms of an apparent contract. If it appears that a contract may be only partly written, courts proceed to the second question, because the parol evidence rule may still apply.

(2) Is that writing the final expression of the parties' agreement? The rule applies only if the writing was the final expression of the parties' agreement. To determine if the writing was a final expression, the court looks at the writing itself and all the surrounding circumstances. For example, the court may be able to tell by looking at the writing that it was really intended to be a tentative draft, an outline, or a memo--and not the final expression of the parties' agreement. This requirement is important, because when parties negotiate, they often send many drafts back and forth, without intending that these drafts be the final expression of their agreement.

(3) Is that writing the complete expression of the parties' agreement? The parol evidence rule applies differently depending on whether the writing is a complete expression of the parties' agreement. Different courts use different methods to answer this question. Courts in many jurisdictions consider the writing itself; the prior statement that one party is trying to persuade the court is really part of the contract; and all other relevant circumstances.

A contract may actually have a clause called a "merger" or "integration" clause that says the writing is a complete expression. However, although clauses like this may help the court decide the answer to the third question, many courts still look at all the relevant circumstances. It is possible for a writing to have an integration clause even though the writing is not really complete! Or the writing may actually incorporate prior statements by reference--as occurred with the Plans and Specifications for the hotel and casino in Case Study 179--in which case the writing is obviously not complete.

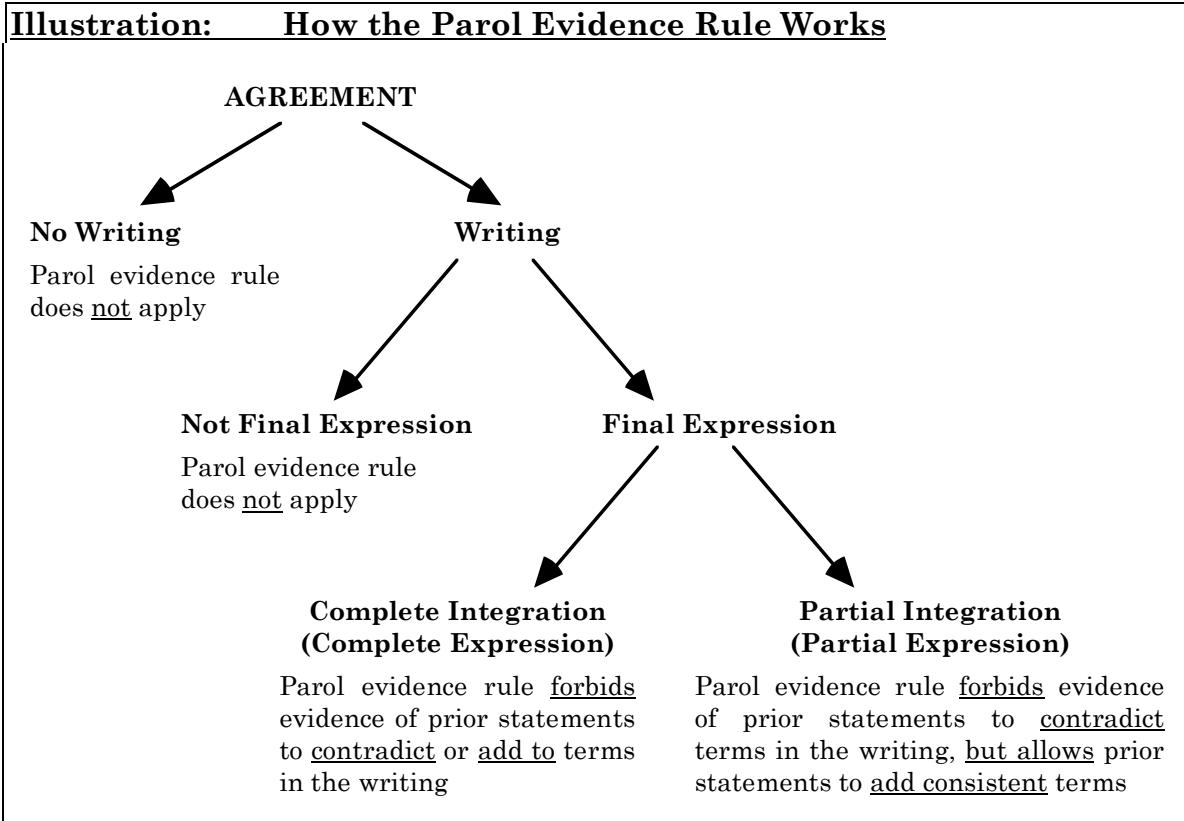
Sometimes the writing itself provides no clear evidence about whether it is complete or not. In trying to answer the third question in that situation, the basic analysis many courts make is an objective one: whether reasonable parties in the situation of the parties to the contract would have included the prior statement in the writing.

If such reasonable parties would have included the prior statement in their final writing, then the contract is called a "complete integration." In that case, courts will not allow evidence of the prior statement to contradict or add to the writing.

But if such reasonable parties would not have included the prior statement in their final writing, then the contract is called a "partial integration." In that case, courts will not allow evidence of the prior statement

to contradict the writing. However, courts will allow evidence of the prior statement to add terms that are consistent with the terms in the writing.

The following chart shows how the parol evidence rule works.



CASE STUDY 190

FACTS Toan Song and Meas Kimyan orally discuss the possibility that Kimyan will lease Song's shophouse. One term they agree about is that the shop's electrical system is old and inadequate, so they will divide "50-50" the cost of installing a new electrical system. The parties do not reach a final agreement about the whole contract, but Song says he will have his lawyer draft and send a proposed lease.

Song's lawyer prepares a final lease contract, and sends it to Kimyan. It says that Kimyan will pay 100% of the cost of the new electrical system. But Kimyan signs the lease without reading it carefully, and without noticing the change.

Kimyan moves into the shophouse, and pays rent according to the written contract. But when Kimyan brings the bills for some electrical work to show Song, Kimyan is shocked to discover that the written contract does not require Song to pay any part of those bills. And Song's lawyer says the parol evidence rule prevents Kimyan from even presenting evidence in court about the earlier "50-50" agreement!

QUESTION OF LAW Does the parol evidence rule prevent Kimyan from presenting evidence of the oral “50-50” agreement about the electrical system which occurred prior to the final written contract?

DECISION Yes. The written contract in this case is final and complete, so the parol evidence rule does not allow Kimyan to present evidence of the prior oral agreement about the electrical system to contradict the final written agreement.

If a court determines that there is a final and complete writing of a contract--a complete integration--then under the parol evidence rule, the court cannot allow prior statements of the parties to contradict or add to the written contract terms. In this case, Kimyan and Song signed a written contract. It is obviously the final expression of the parties’ agreement, because afterwards the parties began to perform the contract, and there was no further discussion of the contract terms until Kimyan brought Song the first bills. And the writing is a complete integration, because reasonable parties in this situation would clearly have put this kind of important term--about who pays to improve the property--in their final written lease contract. In fact, the writing did contain a term about who would pay for the new electrical system: Kimyan! For these reasons, Kimyan cannot present evidence of the parties’ prior statements about the “50-50” payment arrangement to contradict the terms of the final writing. So under the final contract that Kimyan signed, he--and not Song--will have to pay for the new electrical system.

In fact, Kimyan's situation is precisely the kind of case for which common law jurisdictions created the parol evidence rule. And though the result may seem unfair to Kimyan, it was really Kimyan's responsibility to read the contract from Song's lawyer carefully before he signed it. Kimyan did not do that. Of course, if Kimyan had made a real agreement before signing the writing, he could ask the court to reform the writing to reflect the parties’ real agreement. This is discussed in Chapter 7 (“Other Contract Formation Problems”), Section 7.3b, about mistakes resulting from failure to read agreements, and in Section 8.4b, below. But in this case, there was no full real agreement prior to the writing, though there may have been agreement about certain terms. And as discussed elsewhere, parties are generally responsible for reading what they sign. In this situation, the parol evidence rule is more concerned with protecting parties and their written contracts from false claims of outside agreements than it is with protecting parties like Kimyan from their own mistakes.

***** ADDITIONAL REFERENCE:** Chapter 7 (“Other Contract Formation Problems”), Section 7.3b further discusses the limited situations where parties can avoid contracts resulting from the unilateral mistake of failing to read the contract.

CASE STUDY 191

FACTS Suppose the facts are the same as in Case Study 190, except that the final lease Song's lawyer drafts and the parties sign does not say that Kimyan must pay 100% of the cost of the new electrical system. Instead, the written lease says only that the cost of the new system will be paid "as per our conversation."

But when Kimyan brings Song the first bills for the electrical work, Song still says the lease does not obligate him to pay any of them. And Song's lawyer says the parol evidence rule prevents Kimyan from presenting evidence of Song's prior agreement to pay 50% of the cost!

QUESTION OF LAW Does the parol evidence rule prevent Kimyan from presenting evidence of the oral agreement about the electrical system which occurred prior to the final written contract?

DECISION No. In this situation, the parol evidence rule does not prevent Kimyan from using such evidence, because the written lease here was only a partial integration, and Kimyan can present evidence of consistent additional terms.

If a writing is a final but not complete expression of the parties' contract--a partial integration--the court can allow prior statements to add consistent terms to the writing. In this case, the writing is final. But the writing says that the costs of the electrical system will be paid "as per our conversation." That shows that the writing is not complete, because it refers to an outside source of terms. So the writing is a partial integration. Kimyan can present evidence about the prior statements--his conversation with Song--to show that their contract included the "50-50" payment term (a term that is consistent with the rest of the lease). Of course, Kimyan still cannot offer evidence of prior statements to contradict the terms in the writing.

If the writing in Case Studies 190-191 had said nothing at all about payment for the electrical system, that would be a different situation. In fact, it is a more difficult situation, but one which often occurs. In that case, a court might decide that the writing was a complete integration, because reasonable parties might include a term like this in their final written lease if they really want it to be part of the agreement. If a court did decide it was a complete integration, then Kimyan would not be allowed to use evidence of the 50-50 payment conversation to add that term to the writing. So it is always important for a party to read the whole written agreement, to make sure that all the terms that party wants are included in the writing.

WHY IS THIS IMPORTANT? Why do common law courts use the parol evidence rule, and how does it affect parties, contracts, and contract disputes?

The parol evidence rule exists to achieve several goals. The rule's effect on parties is to exclude certain evidence which might otherwise be used to win a contract dispute. In fact, the rule often prevents parties from trying to mislead the court, by saying that contradictory statements which occurred before final contracts were actually part of the contracts--even though the parties did not put those statements into the final writings! If such prior statements could contradict final written contracts, parties could not rely as much on their contracts.

The rule's principal effect on contracts is to strengthen the importance and the power of written contracts. The rule recognizes that when the parties make a contract that is written and final, the parties have usually chosen which terms they really want in their contract. Obviously, prior statements about terms that the parties may have changed or omitted are not as reliable as what the parties chose to put in the final contract. So the parol evidence rule generally says the courts cannot allow such statements to contradict the final writing. And where such writings are complete, prior statements cannot generally be used even to add consistent terms to the writing! This increases the power and reliability of written contracts.

The rule's effect on dispute resolution is to promote efficiency and predictability. In particular, if the parties have written a final and complete contract, the rule requires courts to resolve disputes about the contract terms by focusing on the written contract--not on prior statements and the whole negotiation process which led up to the contract! If the court tried to do that, either it would waste its time re-doing what the parties themselves already did, or it would make mistakes, and the result might be an incorrect interpretation of the contract. For similar reasons, even where a final writing is not complete, evidence of prior statements cannot be used to contradict it.

(2) When the Parol Evidence Rule Does Not Apply

As noted above, the parol evidence rule applies only in limited situations, and there are many situations where it does not apply. Specifically, the rule does not apply:

- (1) where there is no writing;
 - (2) where the writing is not final;
 - (3) where the prior statements are presented to help the court determine whether the writing actually is complete;
 - (4) where the prior statements are presented to help the court understand the meaning of terms that are in the writing;
 - (5) to evidence of statements made after the time of the writing;
- OR (6) to evidence used to show the contract is not valid.

Each of these situations is briefly discussed below.

(1) The parol evidence rule does not apply if there is no writing -- As discussed above, if there is no writing, the parol evidence rule does not apply. If the agreement is partly written, the rule may apply, as also discussed above. But if the agreement is completely oral or implied, or some combination of those two, then the rule does not apply.

(2) The parol evidence rule does not apply where the writing is not final -- As discussed above, the rule does not apply where the writing is not the final expression of the parties' agreement, or at least part of their agreement. Obviously the court will not order the parties to obey a writing that is not the final expression of their contract, such as a draft agreement.

(3) The parol evidence rule does not prevent the court from considering prior statements to determine whether the writing really is complete -- Courts can use evidence of prior oral and written statements to determine whether the writing is a complete expression of the parties' agreement--whether it is a complete integration, or a partial integration. It is hard for courts to determine whether reasonable parties would have included a particular term in their writing if the court cannot even consider what that term is! So courts will consider such prior statements in order to make this decision.

(4) The parol evidence rule does not prevent the court from considering prior statements to understand the meaning of terms that are already in the writing -- The rule does not stop courts from using prior oral or written statements of the parties to understand the meaning of a writing, where that meaning is not clear. The rule applies only to statements of the parties that contradict or add to the terms in the final writing. But that differs from the situation where the court needs help to understand the meaning of a writing. For example, in Case Study 191, the court used prior statements of the parties to help it understand what the term "as per our conversation" in the writing meant. These prior statements did not contradict or add to this term--they merely helped the court understand it. Courts may also use other types of prior statements, such as those made in the prior course of dealing of the parties, to help understand the meaning of a writing that is not clear.

(5) The parol evidence rule does not prevent the court from considering evidence of statements made after the writing was made -- The rule does not prevent the court from considering evidence of statements or other events occurring after the contract was formed. One example of this kind of evidence is evidence of the course of performance. But perhaps the most important type of such evidence is evidence of future agreements, including modifications of the existing agreement. This is important because parties often make such modifications.

CASE STUDY 192

FACTS Somol Transport signed a contract with ABC Construction under which Somol promised to remove the excess material and rubble from a major construction site in the city. According to the written agreement, ABC's engineers would weigh and document exactly what Somol was removing before Somol took it away, and a Somol manager would also make his own records of the process. Basically, both parties wanted a record of how much work they were doing. However, after two weeks of this process, both parties orally agreed to stop it, because it was too slow and burdensome.

A few months later, after Somol had removed nearly all of the material, ABC claimed Somol had violated the contract by removing the material before ABC had the opportunity to make a record! When Somol mentioned the modification Somol and ABC had made after the writing, ABC said the parol evidence rule would not allow a court to consider testimony about that.

QUESTION OF LAW Would the parol evidence rule prevent a court from considering evidence of the modification the parties made after their writing?

DECISION No. The parol evidence rule does not apply to statements or agreements ABC and Somol made after their original written contract.

The parol evidence rule does not prevent the court from considering statements or agreements the parties make after the original written contract. This is true even if that original contract was final and complete, because the rule applies only to prior statements.

In this case, ABC and Somol orally modified their agreement to haul away the excess material and rubble at a construction site. Specifically, they agreed they would stop the weighing and documentation process required by the original written contract. This modification occurred after that writing was signed. So the parol evidence rule does not apply, and does not prevent Somol from presenting evidence about the later agreement of the parties.

(6) The parol evidence rule does not prevent courts from considering evidence that the contract is not valid -- The rule does not prevent courts from considering prior statements for the purpose of determining whether the contract was valid. For example, courts may consider such evidence to see if the contract was invalid because of illegality, lack of capacity, lack of consideration, or other contract formation defects, such as mistake, misrepresentation, duress, undue influence, or unconscionability.

A party can present evidence of a real prior agreement to show that she made a unilateral mistake in signing a writing that does not accurately reflect that prior agreement--even if the inaccurate writing is final and complete. Basically, the mistaken party can ask the court to reform the writing to reflect

the parties' real prior agreement. This is further discussed above, and in Chapter 7 ("Other Contract Formation Problems"), Section 7.3b.

Another important example of evidence the parol evidence rule does not prevent a court from considering is evidence that a contract is actually illegal. Consider the following Case Study.

CASE STUDY 193

FACTS Bora and Sun sign a final and complete loan agreement. The writing says that Sun will loan Bora a certain amount of money, and Bora will repay it at 20% interest per year, which is the maximum rate allowed in the parties' jurisdiction.

However, the agreement is actually back-dated, because of a prior oral agreement between Bora and Sun that Bora would be required to pay interest at a rate far higher than 20% per year. So the real agreement is usurious, although the writing signed by the parties does not show that.

After making a few payments, Bora cannot pay any more, because the real rate of interest is so high. Sun tries to enforce the agreement. Bora tells the court that the agreement is actually usurious because of the back-dating arrangement. But Sun says the parol evidence rule prevents the court from considering such prior statements to contradict the terms of final and complete writings like this one.

QUESTION OF LAW Does the parol evidence rule prevent Bora from presenting evidence of the prior statements of the parties showing that the loan agreement is actually usurious?

DECISION No. The parol evidence rule does not prevent Bora from presenting evidence of prior statements showing the agreement is usurious, because the rule does not apply to evidence offered to show contracts are invalid.

The parol evidence rule does not prevent the court from considering prior statements offered to show that a contract is invalid for reasons such as illegality—even if the writing is final and complete. In this case, Bora tried to present evidence of prior statements of the parties to show that the contract was actually illegal because it was a usurious (back-dated) loan agreement. The parol evidence rule does not prevent Bora from doing this. If the court believes the evidence, Sun will not be able to enforce the loan agreement beyond the maximum legal rate.

*** ***ADDITIONAL REFERENCE:*** Chapter 5 ("Legality"), Section 5.3c contains further discussion about methods of disguising usurious loan agreements.

8.5 When a Court Cannot Interpret a Disputed Term in an Agreement, the Result Often Depends on Whether the Term Is Material

Sometimes a court cannot interpret a disputed part of an agreement, despite using all the rules of contract interpretation, such as those discussed in this Chapter. When a court is unable to decide the meaning of a term in a contract, there are basically two possible results:

- (1) if the court is unable to interpret a material term, then the agreement is generally not enforceable;
- OR (2) if the court is unable to interpret an immaterial term, then the agreement is often enforceable without that term.

The next Sections discuss these two possibilities.

8.5a When It Is Not Possible to Interpret a Material Term in an Agreement, the Agreement Is Generally Not Enforceable

If a court cannot determine the meaning of a material (important) term in an agreement, even with all the rules of interpretation, then that agreement is generally unenforceable. In fact, when an agreement has this problem, it is generally too indefinite and unclear to be enforced. The material terms of an agreement must be definite and reasonably clear for a court to enforce the agreement, as discussed in Chapter 2 (“Real Agreement (Offer and Acceptance)”), Section 2.3b. But when it is impossible to determine the meaning of an important term, then it is impossible for a court to know what to enforce!

Of course, when parties do not specify a material term in their contract, the court may be able to supply a reasonable term. This was discussed in Section 8.3j, which explained gap-fillers. But where the parties do say something about a material term in their agreement, but the court cannot interpret the term, the court cannot supply a reasonable term. This is because parties in this situation did not want a “reasonable” term--they wanted their own term. Unfortunately, they failed to state it clearly enough for it to be enforced. This was explained in Section 8.3j.

Sometimes it is easy to determine that a contract term is “material.” For example, identity and quantity are always material terms in sale of goods contracts--in fact, they are essential. And price terms are material in most if not all kinds of contracts. Unfortunately, there is no complete list of material terms--and it would be difficult to make such a list. This is because what is material depends on the contract and the parties in each case. Some terms are material to particular parties even though they might not be material to other parties in a similar situation. So to decide what is material in each case, the court must look at all the evidence in that particular case. These issues were discussed in Chapter 2, Section 2.3b.

If the part of the agreement that cannot be interpreted is severable, then the court may be able to simply enforce the rest of the agreement without the part it cannot interpret. Severability of parts of agreements was already discussed in Chapter 5 (“Legality”), Section 5.5b, and Chapter 7 (“Other Contract Formation Problems”), Section 7.7c. Severance basically involves dividing a defective agreement into corresponding sets of performances and enforcing the part that is not defective, if that is possible.

But where a term is material, it is often very difficult to sever it and leave an enforceable agreement. For example, there is generally no way to sever a description of the subject matter of the agreement, or the total price, because the whole agreement usually depends on those terms.

Of course, severance may still be possible in a few situations where material terms cannot be enforced. For example, in Case Study 137, suppose the lorry driver Vorn had made a contract to haul two different kinds of wood, with separate prices for each kind. Suppose there was no legality problem. Instead, one of the types of wood was not described clearly enough for a court to interpret it. In that case, the court might be able to sever the unclear part of the contract and enforce the rest.

*** **ADDITIONAL REFERENCE:** Chapter 2 (“Real Agreement (Offer and Acceptance)”), Section 2.3b contains further discussion about the requirement that material terms stated in contracts be definite and reasonably clear; Chapter 5 (“Legality”), Section 5.5b, Chapter 7 (“Other Contract Formation Problems”), Section 7.7c, and Chapter 10 (“Remedies”), Section 10.7c discuss severance of contract terms.

*** **CASE STUDY 194**

FACTS The facts are the same as in Case Study 180. In that case, Pin Vipheak and Tung Yun signed an agreement for the sale of 200 hectares of land. But the agreement was inconsistent about the total price: one part of the contract said it was \$100,000, and another part said it was \$90,000. And the court found no way to resolve this conflict.

QUESTION OF LAW Can this agreement be enforced?

DECISION No. This agreement cannot be enforced because there is no way to interpret a material term: the price of the land.

Where a court cannot interpret a material term in an agreement, the agreement generally cannot be enforced. What is material depends on all the circumstances of the case.

In this case, Pin Vipheak and Tung Yun put two different total prices in their agreement for the sale of the land: \$100,000 and \$90,000. The court cannot resolve this inconsistency. As in many agreements, the price here is

a material term. And there is no way to sever this term--it is too central to the agreement. So the agreement cannot be enforced.

Another way to analyze situations like this is to say that the parties have made a bilateral mistake about the meaning of a material part of their agreement, and neither party has reason to know of the understanding of the other party. Mistakes like this are so serious that the court cannot fairly enforce the agreement, as discussed in Chapter 7 (“Other Contract Formation Problems”), Section 7.3a. So such agreements are void. For example, in Case Study 154, there was a bilateral mistake about the identity of the subject matter--a ship called the *Eternal*--that was so serious the court could not enforce the agreement.

***** ADDITIONAL REFERENCE:** Chapter 7 (“Other Contract Formation Problems”), Section 7.3a contains further discussion about how courts respond to bilateral mistakes about the meaning of material terms.

8.5b When It Is Not Possible to Interpret an Immaterial Term in an Agreement, the Agreement Is Often Enforceable without That Term

If a court cannot determine the meaning of an immaterial (unimportant) term in an agreement, then the agreement is often enforceable without the immaterial term. In this situation, the agreement may still be sufficiently definite to be enforced, because the material terms are definite and reasonably clear, under the standards discussed in Chapter 2, Section 2.3b.

In particular, in these situations, the court may be able to sever the disputed term, as long as it can do so and still leave an agreement the law can enforce. Severance basically involves dividing a defective agreement into corresponding sets of performances and enforcing the part that is not defective, if that is possible. Severance was discussed in Section 8.5a above, and in Chapter 5, Section 5.5b, and Chapter 7, Section 7.7c.

For example, suppose the land sale contract in Case Study 194 was consistent about the price, but contained a provision requiring the seller to provide the buyer with “an extra key for the second story” of a house located on the property. This would probably be an immaterial term. Suppose there were actually many different door locks on the second story of the house, and the court was unable to interpret the “extra key” term. In that situation, the court might be able to simply sever the term and enforce the agreement without it. This is because it seems likely that the court would find a reasonable way to divide the agreement into corresponding performances without the “extra key” term--possibly by throwing the term away.

***** ADDITIONAL REFERENCE:** Chapter 2 (“Real Agreement (Offer and Acceptance)”), Section 2.3b contains further discussion of the requirement that offers be definite and reasonably clear; and Chapter 5 (“Legality”),

Section 5.5b, Chapter 7 ("Other Contract Formation Problems"), Section 7.7c, and Chapter 10 ("Remedies"), Section 10.7c discuss severance of contract terms.

8.6 Interpretation of Contracts in the Cambodian Legal Tradition and the Civil Law Tradition

The approaches of the current Cambodian Contract Law (Decree #38D (1988)) and the civil law tradition appear to be generally compatible with the approach to contract interpretation discussed in this Chapter, except that there does not appear to be anything directly comparable to the parol evidence rule in these traditions.

***** CAMBODIAN LAW PERSPECTIVE:** The approach of the current Contract Law of Cambodia (Decree #38D (1988)) seems basically compatible with the approach to interpretation of contracts discussed in this Chapter. However, there is no indication that courts applying Decree #38D would use a rule comparable to the parol evidence rule.

Basic Provisions

Article 23 of Decree #38D provides that if a "contract is not clear in meaning, that contract shall be interpreted according to the common practice or custom of the place where the contract has been made, but the interpretation shall not conflict with the provisions of this law." Article 23 also states that if "there is any ambiguity, the contract shall be interpreted in favor of the debtor party." Under Article 30, each party to a contract is a "debtor regarding the obligations to be executed."

These provisions seem broadly consistent with the rules discussed in this Chapter. Article 23 appears to say that if a contract is not clear in meaning, the court should apply a general objective standard: the common practice or custom where the contract was made. This standard seems to stress what we have called the "usage of trade," and may also include other objective sources of meaning, such as dictionaries and other accepted reference works. In fact, it seems possible that it could include a wide range of interpretation rules, since those might be described as part of the "common practice or custom" within a jurisdiction.

The provision about "ambiguity" requires that courts interpret ambiguities against the creditor party, meaning the party who is to receive the performance described in the ambiguous provision. This may be somewhat comparable to the "interpretation against the drafter" rules discussed in this Chapter, except that it would be more like "interpretation against the party receiving performance."

Implied Terms

Decree #38D contains a number of provisions that basically seem to require courts to supply terms to parties' contracts. Some of these are discussed below.

Article 2 says that parties to contracts shall "collaborate in an atmosphere of good conscience," and Article 22 requires that a contract "shall be executed honestly," among other things. These provisions may impose a requirement comparable to the "good faith" standard discussed in this Chapter.

Decree #38D also states that a number of fairly specific terms will be considered part of agreements, in certain situations. For example, Article 32 says that the execution of the contract shall occur at the "residence of the debtor," unless the contract has said otherwise. Article 33 basically says that if there is no specific time within which to execute the contract, the debtor can "pay or provide at any time," and the creditor can request payment at any time.

Chapter 2 of Decree #38D, which discusses particular kinds of contracts, contains a number of terms that must be considered part of these specific kinds of contracts, in certain situations. For example, Article 73 states that if no fee is specified in an enterprise contract, the court must determine a fee "according to the customary fees at the work place." In addition, Article 110 appears to state that where a lease has no specific duration, a party must give between one and two months notice to the other party in order to terminate the lease.

***** CIVIL LAW PERSPECTIVE:** The civil law approach to interpretation of contracts appears to be generally compatible with the one discussed in this Chapter, except that civil law jurisdictions do not appear to apply any rule directly comparable to the parol evidence rule. Of course, the exact rules about contract interpretation vary in different jurisdictions, so it is important to check the relevant local law.

It appears that at least some civil law jurisdictions emphasize the subjective approach to contract interpretation more than the objective approach. For example, in France, it seems that courts are supposed to look for the subjective meaning of disputed terms first. This approach appears broadly comparable to the approach discussed in this Chapter.

It seems that many civil law jurisdictions also apply a rule of interpretation that is comparable to the trade usage rule discussed in this Chapter. For example, in France, ambiguous terms are to be interpreted according to local usage and customs.

Some civil law jurisdictions may also apply rules comparable to the rules we have discussed requiring that courts interpret contracts against drafters. For example, it appears that German law regulates standard form contracts, which may often be basically adhesion contracts, and prevents merchants from disclaiming all liability for harm caused by their products. And in France, it appears that courts are also required to interpret contracts against the drafter, particularly in the case of adhesion contracts.

In addition, some civil law jurisdictions appear to apply ideas comparable to what we have called the duty of good faith. And they may actually apply those ideas more broadly than many common law jurisdictions. For example, German law appears to say that parties have a duty of good faith in their contract dealings, and to apply this duty at the negotiation stage, which does not generally occur in common law jurisdictions. And in France, the law says that parties have a duty of good faith in the negotiation and performance of contracts.

Finally, there does not appear to be any rule directly comparable to the parol evidence rule in civil law jurisdictions. However, it appears that many civil law jurisdictions generally limit the use of oral evidence in contract disputes more than common law jurisdictions do. Such civil law jurisdictions apparently try to resolve contract disputes primarily on the basis of documentary evidence.

8.7 Questions for Review

CHAPTER 8 – QUESTIONS FOR REVIEW

1. Why is contract interpretation important?
2. When does contract interpretation occur?
3. What is an important limit on courts' preference to interpret contracts so that they are valid and reasonable?
4. What is the difference between a subjective interpretation and an objective interpretation?
5. What basic approach do many jurisdictions take with regard to subjective and objective interpretations of disputed contract terms?
6. Give examples to illustrate the rule of interpretation that courts must consider the whole contract.
7. In interpreting contracts, how do courts respond to inconsistencies between terms?

8. Give examples of types of terms courts may value more highly than others.
9. What is the plain meaning rule?
10. How can the main purposes of the parties affect the interpretation of a contract?
11. What is the course of performance and what effect does it have on contract interpretation?
12. What is the course of dealing and what effect does it have on contract interpretation?
13. What are trade usages and what effect do they have on contract interpretation?
14. When are disputed terms interpreted against the drafter?
15. When can courts interpret contracts to contain terms the parties omitted?
16. What is the duty of good faith and fair dealing?
17. What are “gap-fillers?” Give examples.
18. What kinds of evidence may courts use to interpret contracts?
19. What is the parol evidence rule?
20. When does the parol evidence rule not apply?
21. What happens when a court cannot interpret a disputed term?
22. Is the Cambodian approach to interpretation of contracts basically compatible with the approach discussed in this Chapter?
23. Is the civil law approach to interpretation of contracts basically compatible with the approach discussed in this Chapter?